An Offer We Must Refuse

The Case for Ending a Residential Condominium's Right of First Refusal

BY ADAM WHITEMAN

The ability of a Condominium Association to step into the shoes of a prospective purchaser of one of its units through what is known as the "Right of First Refusal" is an ill-conceived anachronism that has no present utility, is an administrative waste of time and resources, and is a mine field of potential liability for the modern day real estate practitioner in the residential setting. It is time for a legislative fix.

HISTORICAL BACKDROP

The IICLE on Illinois Condominium Law explains that:

> The right of first refusal or a preemptive right has been enforceable in Illinois since *Gale v. York Center Community Cooperative, Inc.* 171 N.E.2d 30, 21 Ill.2d 86 (1960) in which the Illinois Supreme Court found that this all-important right was not an unreasonable restriction on alienation. Initially an essential component of all documents used for cooperative governance, it came into greater use with the growth of the condominium form of housing.[1]

In *Gale*, the principal question was whether a co-operative housing association may partially restrain the alienability of its members' property interests in order to maintain its existence as a cooperative enterprise. The cooperative was governed by a membership agreement which provided that when a member wishes to withdraw, they must give written notice of their intent to the board of directors. The association then has a twelve-month period in which to purchase the membership at any of the following prices, as determined by the association: (1) the selling price fixed in the notice; or (2) whatever price the member and the association agree on; or (3) the price determined by impartial appraisal. In deciding whether the co-op agreement constituted a "restraint on trade," the court noted that such a restraint "may be sustained...when it is reasonably designed to attain or encourage accepted social or economic ends."[2]

Adam Whiteman maintains a law practice with concentrations on Real Estate Law and Litigation and is a Principal with the firm of Whiteman Borden, LLC in Chicago, IL.

1 IICLE Illinois Condominium Law §9.34, pg. 9-27.

2 *Gale v. York Center Community Cooperative, Inc.*, 21 Ill.2d 86, 92 (1960).

The *Gale* court further stated that "the crucial inquiry should be directed at the utility of the restraint as compared with the injurious consequences that will flow from its enforcement."[3] The Court reasoned that "the law of property, like other areas of law, is not a mathematical science but takes shape at the direction of social and economic forces in an ever-changing society, and decisions should turn on these considerations."[4] Finally, the Court determined that "[t]he restrictions on transfer of a membership are reasonably necessary to the continued existence of the co-operative association."[5] The Court explained that "[i]n order for a contract to be binding, it must be definite and certain in all of its terms...It is sufficiently definite and certain, however, if the court is able from the terms and provisions thereof, under proper rules of construction and applicable rules of equity, to ascertain what the parties have agreed to."[6] The Court then determined that the cooperative housing agreement in question was sufficiently specific to satisfy its test of enforceability.

THE ILLINOIS CONDOMINIUM PROPERTY ACT

"The affairs of a condominium association are controlled by the Condominium Property Act. The Condominium Property Act comprehensively regulates the creation and operation of Illinois condominium associations."[7]

The Illinois Condominium Property Act became law in 1963. Interestingly, the Act contains no express provision granting to a condominium a right of first refusal. One would have expected explicit language addressing this issue if the legislature intended such a right in light of the *Gale* decision. However, the only provision found in the original Act that is remotely relevant is Par. 320 §20 which states:

> It is expressly provided that the rule of property known as the rule against perpetuities and the rule of property known as the rule restricting unreasonable restraints on alienation shall not be applied to defeat any of the provisions of this Act.

Some may argue that this language is the power from which a condominium's right of first refusal is derived. I disagree. The provision itself does not create a right of first refusal. It simply states that the rule against perpetuities and rules regarding restraints on alienation cannot be used to defeat any of the provisions of the Act. Since a right of first refusal is not a "provision of the Act," it is not protected or even invoked by this section.

COOPERATIVE HOUSING VS. CONDOMINIUM PROPERTY

I believe that legal practitioners were too quick to apply the *Gale* decision (which related only to cooperative housing arrangements) to the condominium living setting because of major differences in the overall financial structural differences between the two.

> Residential condominium unit owners should have an absolute right to sell their units without fear of their association interfering.

The restriction on alienation inherent in a right of first refusal makes some sense in regard to the personal property rights in a cooperative living arrangement. But in today's fast moving, highly regulated real estate market, the right of first refusal is an anachronism which no longer makes sense in regard to the real property rights inherent in condominium ownership.

A person who owns a condominium has a deed to their unit which includes a right to use common areas shared by other units comprising the condominium association. As indicated above, the respective rights of the unit holder with regard to the association are set forth in the Illinois Condominium Property Act.[8]

A cooperative is quite a different animal. A person living in a cooperative has no deed in their name and there is no specific statute regulating cooperatives. According to Illinois case law:

> a cooperative is somewhat of a 'legal hybrid' in that the stockholder possesses both stock and a lease, and the relationship between the tenant-shareholder and the owner-cooperative is largely determined by reading together the certificate of incorporation, stock offering prospectus, the stock subscription agreement, and the proprietary lease. The primary interest of every stockholder in such a corporation is the long-term propriety lease and the stock is incidental to such purpose and merely affords the practical means of combining an ownership interest with

3 *Id.*
4 *Id.* at 93.
5 *Id.*
6 *Id.* at 94.
7 *Apple II Condominium Ass'n v. Worth Bank and Trust Co.*, 277 Ill.App.3d 345, 348 (1st Dist. 1995).
8 765 ILCS 605/1 *et. seq.*

the method of sharing proportionately the assessments for maintenance and taxes.[9]

According to Casenotes Underwriters Bulletin, distributed by ATG,

> Unlike condominium ownership, the tenant-shareholders in a cooperative are financially interdependent. There is usually a single blanket mortgage covering the entire property and taxes are assessed against the entire property. Therefore, each member must pay monthly maintenance charges for the cooperative corporation to fulfill its continuing financial obligations to third parties. If one member fails to pay the monthly maintenance fees, the corporation must pay that member's portion of the operating costs. Every member of the cooperative risks losing their respective unit if the corporation cannot pay the taxes or other debts. Consequently, potential purchasers may be required to disclose an extensive amount of financial information. Because of the risks associated with cooperative housing, prospective purchasers often prefer condominium ownership.[10]

In other words, a person can own a condominium with their own mortgage, but a person who owns a share in a cooperative living arrangement generally shares a mortgage with the other shareholders/tenants. Thus, the financial well-being of the co-op owner is a key factor in cooperative living arrangements. Stated another way, in general, an individual cooperative owner is exposed to greater financial risk than an individual condominium owner because the shared financial burdens in a cooperative are greater than the shared financial burdens in a condominium project.

This is why it makes more sense for a cooperative to have a right of first refusal when a shareholder/tenant is attempting to sell their ownership interest. If the rest of the cooperative owners are not satisfied with the financial health of a prospective owner, they can pony up, exercise their right of first refusal, and acquire the departing shareholder/tenant's interest. The co-op owners can then search for a more fitting purchaser if they wish.

PROBLEMS CREATED BY THE RIGHT OF FIRST REFUSAL FOR A CONDOMINIUM SALE

I think it was creative lawyering to rely upon the *Gale* decision to insert right of first refusal language in a condominium declaration. Indeed, a leading practitioner in the field, Jordan Shifrin, suggested in 1986 that the protections of the right of first refusal may be an illusion noting that "it is practically unenforceable and in all likelihood should be automatically waived in most instances."[11]

Mr. Shifrin cites the case of *Wolinsky v. Kadison*,[12] for the proposition that "if a right of first refusal is exercised so that a prospective purchaser is unable to purchase a unit because of his or her race, religion, sex, sexual preference, marital status or national origin, the ordinance [i.e. the antidiscrimination provision of the City of Chicago Condominium Ordinance] has been violated." Mr. Shifrin then explains that "Clearly, associations are now being held accountable for their actions and exercise of the preemptive right can no longer be arbitrarily mandated by a board of directors without a showing of good cause." [13] Similarly, in *Phillips v. Hunter Trails Community Association*, a homeowner's association was ordered to pay actual and punitive damages due to an exercise of a right of first refusal in a racially discriminatory manner.[14]

The IICLE on Illinois Condominium Law writes:

> *Phillips*, coupled with a shortage of mortgage money in the early 1980s, was essentially the death knell for this type of provision as an option. VA and FHA also frowned on this restriction as imposing an unfair burden on open housing and frequently rejected loan applications made for properties that had a right of first refusal. The provision still exists in the older documents, but rarely in any written since.[15]

THE RIGHT OF FIRST REFUSAL HAS REFUSED TO DIE

If, as predicted by the authorities above, the 1980s marked the death knell for the right of first refusal, I am forced to ask my fellow practitioners why it is that we are still required, thirty years later, to require a waiver of the right of first refusal in virtually every single residential condominium transaction? I would say that even when the condominium declaration does not mention a right of first refusal, the title companies still require a waiver "just in case".

THE PERSISTENCE OF THE EXISTENCE OF THE RIGHT OF FIRST REFUSAL HAS CAUSED TROUBLE AND CONSTERNATION

In my over 20 years of experience, I only encountered a single instance of a condominium's attempted exercise of a right of first refusal, and this matter came to my attention as a litigator where I successfully obtained

9 *Sinnissippi Apartments, Inc. v. Hubbard*, 114 Ill.App.3d 151, 156-157 (2d Dist. 1983).
10 Attorneys Title Guaranty Fund, Inc., *Casenotes Underwriters' Bulletin*, https://www.atgf.com/tools-publications/pubs/cooperative-housing.
11 Jordan Shifrin, *First Right of Refusal - Protection or Illusion*, 1986 Ill. Bar J. 398.
12 114 Ill.App.3d 527 (1st Dist. 1983).
13 1986 Ill. Bar J. at 400.
14 685 F.2d 184 (7th Cir. 1982).
15 IICLE Condominium Law, Sec. 9.42.

compensation for my client in the settlement of a legal malpractice case against her prior real estate lawyer.

My client had listed her condominium unit for sale and found a buyer. She was then told by her condominium association that they wished to exercise their right of first refusal. My client's former attorney counseled her to sell her condominium unit to the condominium association, and he told her not to tell the current buyer about this decision in case the association was not able to close. While the first buyer thought they were still under contract, my client's attorney coordinated a sale to the association.

After the sale to the association, the initial buyer sued claiming (1) that they were never even informed that the sale to the association was taking place and (2) that the subject condominium declaration did not actually contain a right of first refusal. This case led to a malpractice claim against my client's former attorney who handled her closing. The matter was ultimately resolved by the attorney's malpractice insurance carrier.

In researching the matter, I was surprised that there was so little guidance in the literature, case law, or statutes about the procedures and ethical obligations an attorney must follow when an association exercises a right of first refusal. The case revealed to me the surfeit of problems faced by an attorney presented with the purported exercise of a right of first refusal.

WHAT DOES CONDOMINIUM DECLARATION SAY?

The attorney must carefully review the Condominium Declaration to determine if the association actually has a right of first refusal. If there is no empowering language in the Condominium Declaration, then there is no right of first refusal. Thus, "a board of managers may not take any action that is beyond the authority granted it under the condominium instruments and the Condominium Property Act." [16]

The problem is that the language in the Condominium Declaration is not always so clear and can require the interpretation of vague and imprecise language. In the malpractice case I handled, the condominium bylaws stated that the Association had a right of first option as detailed in paragraph xyz of the Condominium Declaration. However, upon review, the Condominium Declaration did not contain a paragraph xyz. The drafter forgot to draft right of first refusal language in the actual Declaration. I moved for a summary determination of this single fact, i.e., that that Condominium Declaration in question did not empower the condominium to exercise a right of first refusal. The court agreed.

DEMAND 22.1 LETTER

This is a reason why buyer attorneys should demand responses to 22.1 letters[17] as soon as possible after contracting, and they should demand that the letter address the existence and exercise of a right of first refusal.

INFORM ALL PARTIES, THEIR ATTORNEYS, BUYER'S LENDER AND THE TITLE COMPANY

If a right of first refusal is asserted, there is then the problem of "now what?". In my view, everyone involved in the transaction must immediately be informed that the condominium is exercising its right of first refusal. This means the lender, the agents, and most importantly the buyer's attorney. All parties involved in the transaction must be informed that there is a new buyer on the transaction. The reasons for this are plentiful.

First, it is not fair to string a buyer along thinking they are under contract and preparing to buy a unit that eventually will be sold to someone else. Buyers incur lender costs, appraisal fees, moving fees, attorney fees, etc., in anticipation of a closing. If the condominium association will be purchasing the unit, the buyers have a right to know so they can back out of the transaction without incurring additional financial expenditures.

The same is true for the buyers' lender. Why should they continue forward through the underwriting process if the sale will never take place? In fact, they probably will cancel the loan application process if they are informed that the association has asserted the right of first refusal.

The same is true for the buyers' attorney and real estate agent. They are continuing to monitor the property inspection and closing process. They should not be required to do this if the condominium will be purchasing the unit. Similarly, the real estate agent should be given fair opportunity to know in advance that they might not earn a commission if the condominium ends up being the purchaser rather than the agent's buying client.

Finally, the seller's title company will need to know who the new buyer and lender are for proper title to issue.

DEMAND FULLY EXECUTED CONTRACT FROM THE CONDOMINIUM ASSOCIATION

If an attorney receives a letter from a condo association claiming to exercise a right of first refusal, I think the proper response is to demand a formal letter from the association accompanied by a fully executed contract or other such form which would contractually bind the association to the purchase. I would say a fully executed resolution from the condo board/membership would also be required along with whatever proof of funds or earnest money requirements existed for the initial buyer.

CANCEL THE CONTRACT AND RETURN THE BUYER'S EARNEST MONEY

In my view, the exercise of the right of first refusal by the condominium is, by its very nature, a new contract

16 *Board of Directors of 175 East Delaware Place Homeowners Ass'n v. Hinojosa*, 287 Ill.App.3d 886, 890 (1st Dist. 1997) (quoting 765 ILCS 605/18.4, Historical & Practice Notes, at 129 (West 1993).

17 *See* 765 ILCS 605 22.1.

with a different buyer on the same terms and conditions as the previous buyer. Therefore, the previous contract with the initial buyer ***must be cancelled and the earnest money from that buyer must be returned.***

If the prior contract is not cancelled, then the seller would effectively be obligated to sell under two different contracts to two different buyers, i.e., the initial buyer, and the subsequent condo buyer. One of these contracts must be cancelled.

ADDITIONAL THOUGHTS AND ISSUES

In my view, no two contracts can ever be identical if they involve two different buyers. This is because everyone has different financial circumstances. A condominium can take over a contract of another buyer using a right of first refusal, but now the seller has new risks associated with a buyer (*i.e.*, the condominium) with whom they did not originally intend to contract. This means a seller is forced to accept risks for which they did not contract.

A right of first refusal can also be a source of mischief by the condominium. For example, a condo association could continuously delay a sale by exercising its rejection of the condition of the property by way of inspection. The condo could thereby harass the seller or even cause a price decrease by interfering with prospective sales. A seller might purposely delay requesting the 22.1 letter until the contingency periods are expired to prevent any delays by the condo. But this now seems unfair to the prospective buyer who has spent time and resources with inspections and loan applications.

The questions of inspection and mortgage contingencies can complicate matters. Does the condominium simply step into the exact same contract as the prospective buyer? If the inspection period under the main contract has passed, does the condominium have the right to demand another inspection? The same goes for the mortgage contingency. Thus, can the association assert a right of first refusal only to back out of the deal if they are not satisfied with the inspection or they do not get a mortgage commitment? Such a delay could spell disaster for a seller who is facing foreclosure or short sale time lines.

In light of the power of the condominium association to completely destroy a seller's transaction, I don't believe they should be given the same rights as the prospective buyer they are replacing. In my view, since the association is essentially intervening in the deal, I would argue they would not have a right to conduct any inspection or benefit from a mortgage contingency. I think the association should be required to accept the unit "As Is" and provide proof of funds.

ABOLISH THE RIGHT OF FIRST REFUSAL IN ILLINOIS

According to *Gale*, "restraints on alienation are void unless reasonably designed to attain or encourage accepted social or economic ends."[18] In my view, the right of first refusal constitutes a restraint on alienation that is not reasonably designed to attain or encourage accepted social or economic ends.

The discussion above reveals that the right of first refusal (1) arose out of questionable legal parentage, (2) is extremely difficult to exercise from a practical perspective, (3) can be a source of mischief and harassment by a condo association against a unit owner, (4) can cause irreparable financial harm to a condo owner who is trying to sell their unit, and (5) creates a real risk of malpractice against attorneys involved in trying to carry them out.

Certainly, there are no acceptable social ends in preventing a condo unit owner from selling their unit. This has been made certain by the *Wolinsky v. Kadison*[19] decision which would prevent exercising a right of first refusal for discriminatory purposes.

Likewise, the reality is that there are no economic ends in preventing such a sale. Condominiums have the right to evict unit owners who are not paying their association dues and they can rent said units to make up for the shortfall.

Let us end this fiction. Residential condominium unit owners should have an absolute right to sell their units without fear of their association interfering. Let us follow the example of other states such as New Jersey which passed a law generally declaring that no contract for the sale of a condominium unit shall contain a clause or provision affording an association the right of first refusal. In my view, the law should be both proactive and retroactive.

18 *Gale*, 21 Ill.2d at 93.
19 114 Ill.App.3d 527 (1st Dist. 1988).