

# Rights Of First Refusal (With Sample Clauses)

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Rights of first refusal can take some surprising twists and turns, so it helps to know some of your options in drafting them.

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**A RIGHT OF** first refusal (RoFR) is a common aspect of real estate transactions. For example, a commercial office tenant wants the right to expand into adjacent space if it opens up. Or a farmer wants the right to buy the next pasture. But RoFRs are also found in other areas, such as rights to broadcast sporting events or to develop new drug products. Just about any property, tangible or intangible, may be the subject of a RoFR.

At first blush, granting a RoFR may seem relatively harmless and free of minefields. It does not cost anything to the grantor, at least not in the short run. It will not show up on the balance sheet. The event that triggers it is in the seller's control and may never arise, or, if it does, it may arise long after seller's executives who negotiated it have moved to other positions. It appears to let the market at the time of its exercise set the price. It is less coercive than an option and seems not to require detailed discussion of all the terms and conditions of sale. As a result, a typical RoFR may be as short as half a page and is often not the subject of long negotiations.

The standard right of first refusal clause is familiar to most attorneys, even in a medium detailed variation. The parties probably think they can predict how the clause will work in normal situations. If they go past the normal scenarios, the variations as to what can happen are so numerous that attorneys may not have much appetite for proposing additions to the standard clause. This tendency to accept the standard clause is increased if it is proposed toward the end of the bargaining process; the negotiators are tired and tolerance for more back and forth is low, on both the business and legal

levels. The party getting the right may propose it as a tradeoff against a point for the granting party with immediate, certain benefits. But for the party granting the right (called X here, with the grantee being Y), the consequences of a RoFR—once triggered—may be very real and may greatly reduce X's proceeds from the RoFR transaction.

Y's perspective is quite different from X's. The RoFR is not without positive economic results for Y. If questioned by X, Y may acknowledge that the RoFR may well result in a lower price for X. Otherwise why would Y trade anything away for it? Not to get that lower price would mean Y made a concession and got nothing in return. Some of the proposals in this article protect Y from this unhappy outcome. (Not covered here are the traditional mechanical points regarding a RoFR within a small partnership or closely held corporation when one of the participants is forced to offer his interests to the others. There the price is often the product of a formula and the procedure requires thoughtful drafting but is pretty standard—and works. Also, each member of the group is subject to the same rules.)

This article will present the reader several typical RoFRs, a list of problems that can arise and a series of proposals to deal with at least some of them. Once X becomes aware of the true costs of a RoFR, it may simply reject Y's proposal.

**TYPICAL RoFR** • Although a RoFR can take many forms, it usually consists of the following steps:

X obtains a third-party offer to buy the Object of the RoFR;

X must offer the Object to Y on those third-party terms before X may sell it to the third party;

Y may purchase on those terms; but

If Y does not purchase the Object on the third-party terms, X may sell the Object to the third party on those terms or on terms better for X.

If the RoFR is a bit more thorough, it states that, if the third party does not purchase the Object on those terms within a stated period, X must repeat the process before selling the Object. The text might read as follows:

“During the term of the Agreement, before X may sell the Object to a third party, X shall first offer the Object to Y on the same terms and conditions as are offered by the third party. Y shall have 30 days during which to accept said offer. If Y does not accept said offer within said period, X shall be free to accept the third-party offer. If X does not enter into an agreement with the third party on said terms and conditions and close the transaction within 90 days, X's right to sell the Object to the third party shall expire and the procedure described in this Section shall again be applicable.”

This seems simple enough. The third party has set the market, so the price and terms must be fair.

In a variation, X sets the terms of sale (without having a third party ready to buy) and offers them to Y. If Y turns them down, X may offer the Object to any third party on those terms or on terms no less favorable to X than the terms X offered to Y. If X sets the terms too high, no third party will accept them and X will have to offer the Object to Y again on terms better for Y.

A key difference between these variations is that in the first one, Y is faced with a known buyer who is apparently ready to buy. A tightly drafted RoFR will make it clear that only that third party may buy the Object. In the second variation, only the terms of the transaction are known.

Y may want to limit X's right to sell to a third party to that particular third party, while X will want the freedom to substitute another third party—whether or not an affiliate of the initial third party. Y may have a legitimate interest in who the third party is.

Another variation requires X only to negotiate with Y first:

“During the term of the Agreement, before X may sell the Object to a third party, X shall first offer the Object to Y following the procedures set forth in this Section. Y shall have ten (10) days following the date X first presents Y such offer to decide whether to try to negotiate an agreement for the purchase of the Object from X.

“If Y desires to try to negotiate such an agreement, Y shall, within said 10 day period, deliver to X written notice thereof. Promptly after receipt of such notice, the parties shall commence good faith negotiations exclusively with each other for a period not to exceed 90 days after the date Y gives the requisite notice to X.

“If X does not receive said notice within said 10-day period, or if X receives said notice within said period but X and Y do not enter into a legally binding, written agreement for the purchase and sale of the Object within said 90-day period, X shall be free to enter into an agreement with a third party on terms (considered as a whole) no more favorable to the third party than X offered to Y.

“If X does not enter into a legally binding, written agreement with a third party within the 90 day period, X's right to sell the Object to a third party shall expire and the procedure described in this Section shall be applicable again, and X, prior to selling the Object to a third party, shall first offer to try to negotiate the sale of the Object to Y. For the elimination of doubt, upon each repetition of this procedure, notice shall once again be due.”

Even this more complex variation does not seem very burdensome.

**COMPARISON TO SHOP OBLIGATIONS** • Before considering other factors, a brief comparison of a RoFR with some alternative sales procedures will put it in context.

A RoFR has some similarities to the fiduciary obligations of X's board of directors to “shop” a transaction. Both procedures (RoFR and shop) are intended to find the market for an Object, and to maximize the proceeds to X (and its shareholders). The primary differences, however, are that the comparison and evaluation of a third-party offer for a company or division being sold are left to the business judgment of the board of directors, supported by expert opinions and a well-established history of break up fees and other inducements to the third party to act as a stalking horse. In a normal RoFR, the obligation to take the “better” deal is less forgiving. The comparison of two offers leaves little room for doubt or judgment and the procedure for generating the offers is both formal and vague, leaving the parties in great doubt. Also, the normal RoFR procedure does not offer the third party any break- up fee protections or inducements.

**COMPARISON TO OPTION/PUT** • A RoFR is less coercive and burdensome to X than an option to purchase, but those very characteristics make the RoFR more dangerous. An option gives Y the right to force X to sell the property on specified, negotiated terms and conditions. A thoughtful attorney will

view the option as a separate, complete transaction and negotiate the price, conditions, warranties, and other terms as if the transaction were happening with certainty. Because Y's rights are so clear, X will usually negotiate separate consideration for the rights granted. Furthermore, the period for exercise of the option will more likely be clearly fixed. It gives Y the right to become the owner of the Object. In contrast, a RoFR only gives Y the right to keep a third party from becoming the owner, on terms to be fixed by a process which involves a third party.

The mirror of this scenario is the put, whereby X may force Y to purchase the Object on pre-negotiated terms. Theoretically a put on third-party terms is possible, but it is hard to imagine that Y would ever permit such an open-ended obligation, especially since the third-party terms could never be put to the test, i.e. never forced to buy the Object.

**COMPARISON TO RIGHT TO NEGOTIATE** • Sometimes Y gets only a right to negotiate the purchase of the Object, as mentioned above. If X and Y negotiate in good faith, X has little to fear. But cases show that Y may try to turn this right to negotiate into something more, i.e. into a means of preventing X's sale of the Object to a third party. Proving Y's bad faith in the negotiations is very difficult and expensive and, by the time a court or arbitrator has decided, the third party has probably moved on. Similarly, Y may feel that X is not negotiating in good faith but instead only trying to push Y out of the way. So, unless X has a very clear power to end the process, X faces a real danger. However, if X does have this right to end the process, Y's bargained right may not be worth much.

**TRANSACTION COSTS** • Before considering in detail the particular problems that can arise from these RoFR provisions, consider the RoFR transaction costs—costs that may arise at the time of negotiating the clause or at the time of implementing it—which may result from a RoFR and other risk factors for X:

Defining the Object itself may be more difficult than it seems;

The procedure makes it difficult for X to obtain the true market price for the Object. A third party will be deterred from trying to buy the Object if it knows that Y has the inside track. So the price is depressed. This is the key point;

The RoFR may extend over a long or even indefinite period and the parties and the markets for the Object change. Many unforeseeable factors may arise, affecting the value of the Object and the universe of possible interested parties;

Different business people from the ones who negotiated the RoFR are likely to have to deal with the issue. (Of course this is true of many contracts);

Comparing terms for the sale of the Object offered by two parties may be surprisingly difficult. Some terms are not readily quantifiable; they cannot automatically be converted into dollars. Y may not be able to meet some of the terms a third party offers. Or the terms may be the same, but the likelihood of performance or the nature of the performance (if anything but the payment of cash is required) may be different;

The rights may give Y a basis for obtaining an injunction, stopping X's sale despite X's substantial compliance with the sales procedure;

The procedure increases transaction costs generally. Not only does it require involvement of two potential buyers, it sets up formal, but usually inadequate procedural rules which complicate the sale process;