

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.

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 nu-

merous 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;
- X will anyway want to talk with Y about the sale. Y is a likely buyer. From X's point of view, Y should simply pay the highest price and get the property. If a third party wants it more and is willing to pay more, why should the third party not get the Object and X get the benefit? (A counter argument here from Y: Y may pay a higher price for the main subject of the con-

tract if it feels more confident it will someday get to buy the Object);

- There are other commercial terms directly related to the underlying Agreement (of which the RoFR is often only a part) that may be easier to negotiate and document;
- If Y really wants the property, then the parties could negotiate all the terms now. Of course the value might change substantially before the sale is concluded. And X may not be willing to sell the Object yet;
- X could agree not to give an option or RoFR to any other party—a sort of negative pledge. Alternatively, X could agree to inform Y of X's interest in selling the Object. X could further agree to inform Y of any offer X gets from any third party. To protect X from simple negligence, X should probably couch these obligations in terms that do not give Y rights to sue, possibly in a non-binding side letter.

All these factors increase transaction costs and make it less likely that X will get the true market value of the Object. Put another way, the third party to whom the Object is most valuable is less likely to get it.

While addressing transaction costs, there is another side to them. If the Object is closely related to one that Y is purchasing from X (called here Object 1 and Object 2), Y may be more familiar with Object 2 than a third party, thereby reducing Y's costs of making the necessary investigation or analysis of Object 2. Similarly, if the two Objects both require interaction with X, then Y is already familiar with X and already dealing with X with respect to Object 1. These transaction costs are increased if Object 2 is not somehow related to Object 1, or too much time may pass between the transaction for Object 1 and the one for Object 2 and the information gained goes stale. If indeed Y may enjoy transactional savings by doing the two transactions, then Y is essentially trying to keep those savings for

itself instead of sharing some of them with X in the form of a higher purchase price.

REASONS TO ASK FOR RoFR • From Y's standpoint, there are good reasons for Y to ask for a RoFR, so long as it does not cost Y too much:

- X often underestimates the complexity of the RoFR process. Y claims that the process is simple. Or Y says, "We just need a little paragraph." Y's lawyer then pushes the proposed paragraph across the negotiating table;
- X seldom asks for payment for granting the right or for other burdensome or complex provisions;
- The RoFR is indeed valuable, assuming X ever wants to sell. Even if X wants to sell only to Y, Y knows the RoFR will decrease market pressure, thereby reducing the price Y has to pay;
- Even if Y does not want to buy the Object, the Object is worth more without the RoFR, so Y may be able to exercise its right to buy the Object and flip it, with the difference (pocketed by Y) being the price of the RoFR;
- Alternatively, Y may agree to waive its RoFR, but for a price, possibly a percentage of the sales price;
- If X fails to comply with the RoFR, Y can sue for damages, even if Y was not really a likely buyer;
- Y may really want to buy the Object. As noted above, Y may pay more for Object 1 if Y is more confident of getting Object 2.

DRAFTING ALTERNATIVES • X's first line of defense to Y's request for a RoFR is to say that the process is really quite complex, regardless of the apparent simplicity of the contract provision. The businessmen and even the lawyers have a difficult time judging the likely value or cost of the RoFR and the parties should stick to more easily quantifiable commercial terms. If the Object is most valuable to Y, then Y will be willing to pay the highest

price and Y does not need a contractual right to buy. Then it is in X's best interest to sell the Object to Y. X may also offer not to sell the Object to certain types of buyers or to grant Y the RoFR only before selling the Object to such a buyer.

X may inquire about Y's reasons for requesting a RoFR. Possibilities include Y's concern about the nature of a third-party purchaser or the future use of the Object. X might offer restrictions on both in lieu of granting a RoFR.

X may voice its willingness to grant a RoFR, but only for specified, additional consideration payable immediately. Of course, it is difficult to judge the value or cost of the right and Y may have proposed the RoFR as a tradeoff against other concessions, making the whole valuation process more difficult. X may have to offer Y some other concession with a more immediate cost to X.

Absent the desired result, X may tell Y that X has given the procedure significant consideration and is willing to grant the RoFR but with some protective provisions. X has the counter provisions ready at hand and the resulting RoFR will protect Y's legitimate interests and still not be longer than two pages. The provisions are discussed below.

Earnest Money

If the RoFR procedure begins with required negotiations, as with poker Y should have to put up some funds to get into the game. Otherwise Y has no disincentive to slowing down X's sale. A possible provision:

"Should Y desire to negotiate such a purchase agreement, Y shall [give the appropriate notice] and shall pay X the sum of \$_____, which sum shall [not] be credited against any amount Y may otherwise be required to pay X should X and Y enter into an agreement for the purchase and sale of the Object.

"Should X and Y not reach agreement within said period, X shall, within five (5) days after expiration

of said period, submit to Y a detailed written offer to sell the Object to Y, which offer shall be irrevocable and not be subject to change for a period of five (5) days from the date of its receipt by Y. Y may extend this period from five (5) to ten (10) days by the payment, received by X within said five (5) day period, of \$_____, which sum shall [not] be credited against any amount Y may otherwise be required to pay X should X and Y enter into an agreement for the purchase and sale of the Object."

Termination

If the RoFR is part of a larger, primary agreement—as it normally is—the status of that agreement should have an effect on the RoFR. Likewise, X may not want to have the Object tied up forever, even "only" with a RoFR. Exactly when the primary agreement terminates in relationship to the then-current step of the RoFR may also make a difference. Some possible provisions:

"X's obligations under this RoFR shall terminate without notice on the 12 month anniversary of the date hereof";

"X's obligations under this RoFR shall terminate without notice if, at any time prior to closing of the sale [vesting of title] of the Object, (a) Y shall breach the Agreement, (b) Y shall give notice of termination of the Agreement or (c) the Agreement shall otherwise terminate in accordance with its terms or in accordance with applicable law, except by reason of X's breach of the Agreement";

"X's obligations under this RoFR shall terminate without notice if, at any time prior to [earlier date, such as Y's acceptance of X's offer to sell the Object], (a) Y shall breach the Agreement, (b) Y shall give notice of termination of the Agreement or (c) the Agreement shall otherwise terminate in accordance with its terms or in accordance with appli-

cable law, except by reason of X’s breach of the Agreement”;

“X’s obligations under this RoFR shall not terminate regardless of the termination of the Agreement unless such termination is due to the uncured breach of the Agreement by Y. In such event, X’s obligations shall terminate upon the effective date of the termination of the Agreement, but no such termination shall affect any obligation entered into by X and Y prior to such termination and any offer made by X shall not be subject to withdrawal or modification for a period of 10 days after it was made and last modified”;

“X’s obligations under the RoFR shall not terminate regardless of the termination of the Agreement, provided, however, that the RoFR shall not apply if it would otherwise apply only due to failure of X to have closed the sale of the Object to a third party within the permitted time period. [i.e. no offer obligation].”

Note: For avoidance of disputes, the provision should make clear what effect—if any—the termination of the underlying agreement has on RoFR proceedings that have already begun and possibly on agreements entered into pursuant to the RoFR. For example, if Y has fulfilled all its obligations to purchase the Object except for the closing when the underlying agreement expires by passage of time, then Y should probably be permitted to close the purchase transaction. Y may want its agreement with X regarding the Object to be by its terms completely independent of the agreement with the RoFR.

Note: If Y enters a contract for the Object pursuant to the RoFR and then breaches it, X might reasonably expect that the RoFR itself expires, i.e. that X may reoffer the Object without following the RoFR procedure. But if the third-party offer

is substantially lower on the second attempt to sell the Object, Y might claim it could perform at that lower price and try to enforce its “rights.”

Some courts will permit X to stop the RoFR proceedings in mid-stream, regardless of Y’s reliance and expenditures. Y may want some assurances on this point and X may want greater flexibility and be willing to pay for it:

“[Except as otherwise provided herein,] X may terminate the procedure described herein at any time and withdraw any offer it has made to Y by written notice of such termination given to Y, provided, however, that X shall pay Y its reasonable, out-of-pocket expenses [and a fee of \$_____].”

“[Except as otherwise provided herein,] X may terminate the procedure described herein at any time by written notice given to Y.”

A variation on this theme is Y’s complaint that X has essentially accepted a third-party offer but waited until expiration of Y’s RoFR to formally accept it, thereby denying Y its rights under the RoFR. At one extreme of the continuum, X signs an otherwise binding agreement with the third party to sell the Object but by its terms the agreement is effective only after the expiration of the RoFR. At the other end of the continuum, X and the third party have entered substantive discussions regarding the Object and intend to conclude a deal, but have not reached an agreement at the time the RoFR expires. Although favoring X, the clearest solution to this continuum problem is to trigger Y’s rights under the RoFR only as a condition to X’s right to transfer title, i.e. nothing short of signing the deed or bill of sale regarding the Object triggers Y’s rights. Anything short of that standard is very difficult to enforce. X and especially the third party will also want to foreclose any right of Y to undo the deal.

Define The Object

The Object may be a piece of real estate, right to televise a horse race, or an active drug ingredient yet to be developed or a business division. X will want to be able to dispose of assets related to the Object without having to go through the RoFR process. Is the Object described precisely enough that X is confident that Y has no rights to the related assets? If X wants to sell less than all of the Object, what are Y's rights? May Y demand that the full Object be offered? If X sells less than the full Object, does Y have rights to the remaining portion of the Object? If Y did not win or did not bid on the first piece of the Object, has Y waived all its rights? If Y bid and then breached its obligations, did the RoFR expire as to the remainder of the Object? If Y does win the bidding procedure, what precisely does Y get? Does a business division include assets shared with other divisions? If a third party wins the process and then succeeds in expanding the definition of the Object, does that give Y rights to force a new round of bidding?

Similarly, if X offers the Object as part of a larger package, may Y bid only on the Object or may/must Y bid on the whole package? How is the third-party bid allocated to the Object if the bid covers more than just the Object and Y bids only for the Object? X and the third party have an interest in allocating most of the purchase price to the Object, to discourage Y.

Define The Trigger

Although most RoFR language starts with "if X wishes to sell the Object" there are transfer events in the gray zone that may or may not trigger Y's rights. May X transfer the Object by gift (possibly to a limited group of family members) or bequest outside the RoFR? May a small group transfer the Object among its members? May X change the means of ownership of the Object? If X is a corporation or LLC, what effect does a change in control have on the ownership of the Object? Does the

recipient of the Object take it subject to the RoFR? If X goes into bankruptcy, what is the effect on a transfer on the RoFR? Of course, Y can only hope to frame its rights in a way that will persuade the bankruptcy court to honor them.

Comparing Offers

Comparing two offers containing terms that are not easily quantified is the subject of much litigation. Some ground rules would reduce the likelihood of such disputes. Of course, Y may want uncertainty, to slow down X's sale to the third party and lower the price. Y also wants to reduce X's discretion, which could be exercised to Y's detriment. Some provisions:

"In comparing offers made by Y and any third party, X may place a value on any non-financial terms, including the likely ability of the parties to perform, and X's judgment reasonably exercised shall control. If Y challenges X's judgment, (a) Y shall have the burden of proof, (b) Y's sole remedy shall be a claim for monetary damages, and (c) Y hereby waives any right it may have to equitable relief";

"In comparing offers made by Y and any third party, X's reasonable judgment as to which offer is superior shall be determinative";

"In comparing offers made by Y and any third party, X may consider the terms of each offer as a totality, without regard for each term of the respective offers";

"In comparing offers made by Y and any third party, X shall consider each material aspect of the two offers individually (and not all aspects as a totality) and each aspect of the third party's offer must be at least as advantageous to X as Y's";

“In comparing offers made by Y and any third party, X shall consider each material aspect of the two offers individually (and not all aspects as a totality), but may disregard immaterial differences between each aspect of Y’s offer and the corresponding aspect of the third party’s offer.”

Break-up Fee

To induce the third party to pursue an Object which is the subject of a RoFR and provide a true indication of the market price, some payment to the third-party purchaser may be necessary in case Y does exercise its option and buys the Object. Possibly Y should be the source of the payment:

“If Y exercises its rights hereunder to the detriment of a third party, in addition to the amounts set forth in Y’s offer payable to X, Y shall pay to said third party at closing an amount equal to ___ percent of the purchase price.”

“If Y exercises its rights hereunder to the detriment of a third party, in addition to the amounts set forth in Y’s offer, Y shall pay to third party at closing an amount equal to third party’s reasonable, out of pocket expenses.”

Bad Faith

Y may indeed want to slow down the process, scaring off the third party without having to buy the Object. There is no readily apparent way to prevent these slow-down tactics. Possibly the threat of a damages claim could speed things up:

“If Y exercises its rights hereunder in bad faith, unreasonably delays the RoFR procedure or breaches any agreement entered into between it and X pursuant hereto, X shall be entitled to damages no less than the amount offered by the third party and X’s out of pocket expenses without any reduction for the possibility that the third party might not perform.”

Another aspect of bad faith would be the failure of X to disclose Y’s RoFR to the third party. To avoid doubt on this point, Y might want to insert in the underlying agreement X’s affirmative duty and Y’s right to disclose Y’s RoFR, regardless of any confidentiality provision in the agreement.

Terms Of Offer

Y may—intentionally or unintentionally—gum up the works by giving a partial response to X’s offer. Some rules could clarify the procedure and make X’s sale to the third party easier:

“If Y does not make a written counter offer to any aspect of X’s offer or if Y’s counter offer contains terms which a third party is unlikely to be able to match, due to their unique nature, X shall be permitted to ignore those terms in any negotiations with and offer to a third party”;

“If Y does not make a written counteroffer to any aspect of a third party offer, X may unilaterally revise that aspect of Y’s counteroffer to the benefit of the third party, without reoffering the Object to Y on those revised terms”;

“Any terms rejected by Y without a counteroffer may be disregarded and X may modify these terms without first reoffering them to Y. The same is true with respect to any terms proposed by Y which the third party cannot be reasonably expected to fulfill within ___ days, without expenditure of a significant amount.”

Note: Y always wants a chance to meet the third party offer, even if the third-party offer is better for X than the one X has proposed and Y has turned down. This fact tends to push the third party to make its top offer, but it discourages the third party from getting involved at all unless X or Y is required to make some payment to third party for its efforts and risk.

OTHER FACTORS TO CONSIDER • Besides general drafting points covered above, the parties to the RoFR should consider the following aspects:

- *Rule against perpetuities.* An unlimited restriction on the sale of the Object may run into this challenge;
- *Unreasonable restraint on alienation.* A court could invalidate a particularly onerous RoFR under this theory;
- *Antitrust and government regulations.* One offer may bring antitrust and Committee on Foreign Investment in the United States (CFIUS) complications that would not be apparent from a limited review of the commercial terms.

CONCLUSION • X's grant of a RoFR may, if thoughtful, be an inexpensive way of getting to a mutually satisfactory conclusion of difficult negotiations. But, as this article points out, there can be many twists and turns along the way, from contract signing to exercise of the RoFR and ultimate purchase of the Object. On reflection, the attractive clarity and brevity of a standard RoFR provision give way to the normal complexities and length common to legal agreements that try to regulate the unknown. Keeping a RoFR short only plays into Y's hands and prevents X from achieving the highest price.

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PRACTICE CHECKLIST FOR Rights Of First Refusal (With Sample Clauses)

Regardless of the precise language of the RoFR, the following key points should be kept in mind, especially by X, in drafting any RoFR:

- How can X encourage a third party to bid aggressively for the Object?
- What is the Object? What will it be at the time of RoFR exercise?
- When does the RoFR end?
- What is the effect of the end or the breach of the underlying agreement?
- Can X stop the sales process once it started?
- Who bears the third party's costs?
- How is Y's offer to be compared with that of the third party? Assume they will not match up 1:1.
- How can the process be sped up?
- How can the third party be sure Y will not get a last second injunction?