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Why Rights of First Offer and Rights of First Refusal Don't Work



Joshua Stein.

In any place where I have ever lived, my bathroom sink had a lever in it that was supposed to control the drain stopper. In each case, however, the drain stopper either didn't hold the water in the sink or it got stuck or it got tangled up with hair or the lever handle disconnected itself from the stopper. If I ever had the drain stopper apparatus fixed, it never stayed fixed. It seemed like a great idea, but it never actually worked.

Those drain stoppers remind me of the rights of first offer and rights of first refusal (ROFOs and ROFRs) that often find their way into joint venture agreements and ground leases. These clauses seem like a great idea. They say a party to a joint venture agreement or a ground lease can't sell their position unless they first give the other party an opportunity to buy it—the right of first refusal or right of first offer. That has a ring of fairness and logic. It is even sort of creative.

But if you ever actually try to use one of these clauses, or have one used against you, they are like the drain stoppers in every bathroom sink I have ever known. They ultimately don't work, although you can never predict exactly when, why or how they won't work. Sometimes, they won't work in multiple ways.

I have recently lived through three adventures with three clients involving these clauses, none written by me. Before that, I encountered several other ROFOs and ROFRs. Every time, the contractual language failed to answer some of the most basic questions that should have been answered. And to the extent the contractual language did define the rights and obligations of the parties, those rights and obligations in some ways made little or no sense.

Start with the simple matter of timing. Invariably, the ROFOs and ROFRs I've seen have offered such a short decision period as to be useless. Typically, the response period to any ROFO or ROFR notice is 30 days. That's not enough time for a real estate investor to figure out whether they want to commit to close a major capital transaction and then make sure they will have the necessary financing to do so. Even though they won't actually have to close within 30 days, they will have only that time in which to decide and commit to close—with potentially serious consequences if they default.

If an investor receives any ROFO or ROFR notice, an opportunity to buy out their partner or counterparty, then there is no particular reason to think that they will be in a mood to undertake a major capital transaction at that particular moment. If they don't exercise their rights, though, then typically they will have little control over who comes into the deal. So perhaps as a self-protective measure, they should try to exercise their ROFO or ROFR rights and then "flip" the deal to someone else, perhaps at a profit, but in any case as a way to protect themselves from the unknown.

Though that strategy makes sense, often the language of any ROFO or ROFR will make it impossible to "flip" the deal or bring in someone else. Only the party who originally received the ROFO or ROFR notice can exercise the right. In one case, the language suggested if that party wanted to make a deal to bring in someone else, then they would first have to give a second ROFO or ROFR notice to whoever had started the process and then wait 30 days. Any such exercise would defeat any effort to bring someone else into the deal.

In another case, a ROFO or ROFR clause said it didn't apply if the transaction involved a simultaneous sale of multiple assets. The would-be seller, therefore, simply threatened to throw in a Motel 6 in Wichita, thus defeating the ROFO or ROFR entirely, for whatever it would have been worth.

If a party who receives a ROFO or ROFR notice decides to exercise their rights, then what happens? Do they have to put up a deposit? Is there a contract of purchase and sale? Exactly what price applies? Do you subtract out brokerage commissions avoided? Do you subtract out other items that might be subtracted under an ordinary contract? Does the seller make any representations and warranties? And what happens if the buyer under this pseudo contract decides not to perform? Does this put them in default under the ground lease or joint venture?

For the reasons in this column and many others, no one should place great weight on ROFO or ROFR clauses as a source of any reliable protection or value in a deal. For the most part, they just cause trouble and surprises.

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