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IN BRIEF

SHAREHOLDER EXIT PATHS: CHOOSING BETWEEN RIGHT OF FIRST REFUSAL AND RIGHT OF FIRST OFFER

Introduction

It is common where there are two or more shareholders to enter into a shareholders' agreement (SHA) or joint venture agreement (JVA) to clearly define the rights, responsibilities, and governance structure amongst them. As these are private arrangements, their effectiveness relies on ensuring long-term stability, while also including provisions for an orderly exit. This ensures that a shareholder's departure does not unduly harm the interests of other shareholders or disrupt the company's operations.

An SHA/ JVA, more particularly when the investee company is a private company, usually contains certain restrictions, whereby the shareholders are precluded from freely transferring their shares. The concept instead revolves on the spirit of orderly and pre-agreed exit processes for the shareholders.

Amongst many variations of pre-agreed transfer restrictions, the most usual form of restriction is aimed at providing the non-exiting shareholder with the opportunity to increase its participation in the venture, by purchasing the shares of the exiting shareholder. This is usually referred to as either the 'right of first refusal' (ROFR) or 'right of first offer' (ROFO), and both have minor variations from each other aimed at providing the non-exiting shareholder a 'first bite at the apple' in case a shareholder plans to exit a venture.

ROFR and ROFO

Since both ROFR and ROFO are contractual provisions, there are many variations to these contractual arrangements:

- In ROFR, the onus on price discovery essentially resides on the shoulders of the exiting shareholder who must first secure a firm offer from a third party interested in purchasing its shareholding at a specific price or valuation. Once this is done, the exiting shareholder approaches the non-exiting shareholder with the terms of the third-party offer. Upon receipt of this communication from the exiting shareholder, the non-exiting shareholder has the option (right but not an obligation) to instead cause the exiting shareholder to sell the shares to the non-exiting shareholder, at a price and on terms which are the same or better than the ones offered by the third party to the exiting shareholder. If the non-exiting shareholder rejects the offer, the exiting shareholder is then free to sell the shares to the third party.

- On the other hand, in ROFO, the onus on price discovery is usually left with the non-exiting shareholder, as the exiting shareholder communicates to the non-exiting shareholder its desire to exit and based on this communication, the non-exiting shareholder makes an offer to purchase the stake of/ shares held by the exiting shareholder at a certain price/ valuation. If the exiting shareholder finds the offer acceptable, the parties proceed with the sale to the non-exiting shareholder. If, however, the offer is viewed as not sufficient, the exiting shareholder is then free to approach third parties to purchase the shares/stake at a price which is higher and on terms which are the same or superior to those offered by the non-exiting shareholder.

- There are also variations to ROFO, where the responsibility for price discovery does not rest with the non-exiting shareholder and instead the exiting shareholder must propose a price for his shares/stake. Additionally, a hurdled ROFO has recently emerged as a variation of the traditional ROFO, where certain percentage-based price hurdles are placed on counter offers to ensure that they qualify as a valid offer, to avoid someone to game the original offer by a nominal amount.

Challenges for Exiting Shareholders Under ROFR

While ROFR protects non-exiting shareholders, it can be problematic for exiting shareholders. The very existence of ROFR may deter third-party buyers, as they know that even after conducting due diligence and engaging in lengthy negotiations, the non-exiting shareholders could simply match their offer and purchase the shares. For third parties, this presents a risk: after investing significant time, money, and resources into a deal (such as management time, fees for the lawyers and other advisors), their efforts may be wasted if the non-exiting shareholders exercise their ROFR. This uncertainty discourages third-party's interest and effectively chokes a competitive sale process, making it harder for the exiting shareholder to secure an optimal deal.

ROFO: A Smoother Path for Exiting Shareholders

In contrast, ROFO offers a more straightforward process for exiting shareholders. The prospective buyer would start the negotiations only after the non-exiting/ remaining shareholder(s) have already declined to purchase the shares of the exiting shareholder(s). Therefore, the prospective third-party buyer would remain assured that the exiting shareholder would have the ability to sell its shares upon successful negotiations between the potential third party buyer and the exiting shareholder. More so, the exiting shareholder may seek a more lucrative and favorable offer from a potential third-party buyer, as he already has a benchmark offer from the non-exiting shareholder.

Why ROFR is More Beneficial to Non-exiting Shareholders

As mentioned above, while ROFO benefits exiting shareholders, ROFR offers significant advantages to non-exiting shareholders:

- **Market-tested Price:** With ROFR, non-exiting shareholders can see the price offered by and negotiated with the third-party buyer before deciding whether to match it. This ensures that the price has already been tested in the market.

- **Deterrent to New Investors**: As mentioned above, ROFR discourages new investors from investing time and effort into a potential purchase, knowing that non-exiting shareholders could easily exercise their ROFR and buy the shares themselves. This gives non-exiting shareholders a stronger negotiating position.

- **Control Over New Shareholders**: ROFR allows non-exiting shareholders to control the entry of the new shareholders, which is crucial when sensitive information, technology, or proprietary know-how is involved. They can prevent undesirable parties from entering the company by exercising their ROFR.

- **Maintaining Power Balance**: ROFR helps in maintaining the balance of power between the shareholders. For the largest investor/ shareholder this is important as the ROFR assures him that he may be able to continue to maintain his voting power relative to the other shareholders, if one of the minority shareholders decides to sell its shares to another minority shareholder which may enable the buying shareholder to threaten the control of the largest shareholder.

Making a Choice

When drafting or negotiating a SHA/ JVA, there is often a dilemma over whether to incorporate a ROFR or ROFO. The choice depends upon a lot of factors, such as the rationale for entering into the agreement, type of investor (strategic or financial), nature of the investee company (start-up or established business), the investment timeline, exit strategy, long term goals and most certainly the negotiating strength and position of the parties.

For example, in private equity transactions, investors usually have a defined investment horizon, and therefore they resist any restriction on their ability to transfer the shares and often refuse to grant any type of pre-emption rights to the promoters. If, however, the promoter insists (so that the business remains intact within the close group) at best, the investors may agree to a ROFO to the promoter. ROFO provides the investor with a price to start the negotiation with the third parties. On the contrast, the promoters would like a ROFR in their favour, as this gives them an opportunity to acquire the investor shares by simply matching or slightly sweetening the same with a little higher price than what has been offered by the third party.

In strategic investments or joint ventures, where the parties have come together with common business goals, they agree for a more rigorous pre-emptive right (usually ROFR) as the objective is to operate and grow the JV together with the expertise of one another. If, however, for some reason any party decides to exit, the business remains with the remaining shareholder(s) who have put in their time and efforts to nurture the JV.

In essence, ROFR is favored by those shareholders who intend to stay long term, whereas ROFO is seen to be favored by likely sellers. Though ROFR can be a lengthy and time-consuming process, ROFO despite leading to a fair result (from the perspective of value of shares of the exiting shareholder) in reality is far less common than ROFR. In practice, it is being increasingly seen that a Hurdled ROFO is being adopted as a negotiated means between the ROFR and ROFO.

Key Considerations When Drafting ROFR/ROFO Clauses

When drafting ROFR or ROFO clauses, the following points should be carefully considered:

- Whether there should be any restriction on the operation of these rights during the initial years (helpful for startups);
- Partial or full transfer of shares;
- How long the right should remain in effect – always or for a specific number of years;
- Process for determination of sale price;
- Time limit for exercising the rights and closing the transaction;
- Exceptions such as transfers to affiliates;
- Continued applicability of these rights after a third-party purchase; and
- Minority and majority shareholders protection rights - tag along and drag along rights.

Some parties agree to have both ROFO and ROFR, but mostly, either of them is agreed upon. Usually the same rights (whether ROFO and/ or ROFR) are given to all the shareholders, however, in certain situations, these rights may only be given to one set of shareholders (for example majority shareholders).

This newsletter has been contributed by:

Abhinav Rastogi, Partner, Dua Associates, Gurugram

For further information contact:

Abhinav Rastogi, Partner, Dua Associates, Gurugram
Email: abhinav@duaassociates.com

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