

RETHINKING RIGHTS OF FIRST REFUSAL

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### **Abstract**

As typically employed, the contract provision known as the right of first refusal provides the grantee with a contingent option to purchase an asset if the grantor elects to sell. Conventional wisdom teaches that rights of first refusal are employed to avoid a costly future breakdown in bargaining between the grantor and the grantee and to guard against a sale to an undesirable party. In this Article I argue that the traditional justification is faulty. Because the provision deters potential buyers, the right of first refusal is costly for the contracting parties, and, if the sole aim of the contracting parties is to eliminate a future breakdown in bargaining, that goal can be achieved at a lower cost by committing to a paper auction. Having rejected the traditional justification, I go on to argue that the real motivation behind the adoption of rights of first refusal, at least in co-venturing relationships, must be a desire to inhibit the unilateral departure of a participant. I also argue that the use of rights of first refusal in other relationships, such as the lessor/lessee relationship, may be explained as an example of suboptimum standardization of contract terms. I conclude with a few thoughts concerning the implication of this analysis for private contracting and for legislatures that are considering mandating rights of first refusal.

JEL Classification: C70, D21, D23, D81, D82, D83, G34, K12.

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## INTRODUCTION

Among the many provisions of the incorporating documents of a close corporation, an item will often appear (usually well towards the back) labeled “Rights of First Refusal.” By adopting this provision, the shareholders of the corporation promise that they only will sell their shares after negotiating a price with a third party and offering the shares at that price to their fellow shareholders. Although the details will vary, such rights of first refusal are ubiquitous in commercial contracts and encumber assets ranging from gas stations to oil pipelines, from shares of stock to livestock; and they are not limited to constraining sales or even to restricting the disposition of property.<sup>1</sup>

In the typical right of first refusal arrangement, at least three parties are implicated -- the owner and rightholder who have contracted for the grant of the right and one or more potential third-party buyers. This Article investigates the economic impact of the grant on each of these parties, and seeks to determine why the contracting parties make such commitments and why they adopt this particular instrument.

This Article has three primary goals:

*1. Demonstrate that rights of first refusal are costly for the contracting parties.*

The few commentators who have considered the matter have suggested that rights of first refusal are economically innocuous<sup>2</sup> or, beyond transaction costs, simply transfer value from the

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<sup>1</sup>*See infra* Part I.A-B.

<sup>2</sup>*See, e.g.*, 3 ERIC MILLS HOLMES, CORBIN ON CONTRACTS § 11.3, at 484-85 (Joseph M. Perillo ed., rev. ed. 1996) [hereinafter CORBIN] (a contract that grants a right of first refusal “for a definite period operates very little, if any, as a restraint on alienation by [the owner]. . . . Rather

grantor to the rightholder.<sup>3</sup> If, at worst, a right of first refusal simply transferred value between the contracting parties, little justification would be needed for its adoption. The transfer could be compensated for ex ante, if necessary, and the benefit beyond transaction costs arising from the instrument would represent added value to be divided by the contracting parties. My first goal,

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than restraining alienation, the right enhances it by providing two buyers when property is sought to be sold.”).

<sup>3</sup>Marcel Kahan has analyzed the economics of rights of first refusal and the magnitude of the value transfer from the grantor to the rightholder. He suggests that negotiation and dispute costs detract from a zero-sum transfer between the parties to the contract. See Marcel Kahan, *An Economic Analysis of Rights of First Refusal* (July 1997) (unpublished manuscript, on file with author).

The literature on rights of first refusal is not extensive. Professor Kahan’s piece is the only in depth economic analysis of the instrument of which I am aware. The most extensive doctrinal treatment is provided by CORBIN, *supra* note 2, §§ 11.3-4. See also 1 E. ALLAN FARNSWORTH, *FARNSWORTH ON CONTRACTS* § 3.23a (2d ed. 1990); 1 SAMUEL WILLISTON, *A TREATISE ON THE LAW OF CONTRACTS* § 4:25 (Richard A. Lord ed., 4th ed. 1990). In the close corporation setting, see F. HODGE O’NEAL & ROBERT B. THOMPSON, *O’NEAL’S CLOSE CORPORATIONS* §§ 7.01-48 (3d ed. 1996), for a description of the need for, history, and use of stock transfer restrictions, in general, and rights of first refusal, in particular. This treatment is extensive and practical. The use of rights of first refusal in the close corporation is examined from an economic perspective in FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 228-32 (1991) and ROBERT C. CLARK, *CORPORATE LAW* 763-65 (1986).

Legislative grants of rights of first refusal have been the subject of a number of articles. Those germane to this Article include Bernard V. Keenan, *Condominium Conversion of Residential Rental Units: A Proposal for State Regulation and a Model Act*, 20 U. MICH. J.L. REF. 639; Thomas J. Houser, Note, *A Comparative Study of the Former Owner’s Right of First Refusal Upon a Lender’s Resale of Foreclosed Agricultural Land: A New Form of State Mortgagor Relief Legislation*, 13 J. CORP. L. 895; and Robert M. Lawless, Note, *The American Response to Farm Crises: Procedural Debtor Relief*, 1988 U. ILL. L. REV. 1037. Finally, a handful of cases move beyond doctrinal basics to analyze the purposes and implications of rights of first refusal. See *Pincus v. Pabst Brewing Co.*, 893 F.2d 1544 (7th Cir. 1990) (examining the creation and triggering of a right of first refusal on the sale of a subsidiary); *LIN Broadcasting Corp. v. Metromedia, Inc.*, 542 N.E.2d 629 (N.Y. 1989) (determining that a right of first refusal is not converted into an option by an owner’s offer to sell); *American Broadcasting Cos. v. Wolf*, 430 N.Y.S.2d 275 (N.Y. App. Div.), *appeal dismissed*, 413 N.E.2d 1173 (N.Y. 1980), *aff’d*, 420 N.E.2d 363 (N.Y. 1981) (focusing on the appropriate damages for the breach of a right of first refusal on the services of an employee).

however, is to demonstrate that parties adopting rights of first refusal incur more than dispute and negotiation costs. Rights of first refusal discourage potentially high-valuing third-party bidders from entering a contest to purchase, and thus the instrument reduces a seller's expected realization. For this reason the right of first refusal proves to be costly for the contracting parties, in aggregate.

*2. Rebut the idea that rights of first refusal provide efficient insurance against bargaining breakdown.*

Although the right of first refusal is demonstrated to create a net cost for the contracting parties, the right does provide benefits. Several books and articles dealing with rights of first refusal in the close corporation context suggest that the device is used to assure compatible management, maintain family control, or otherwise protect the remaining shareholders from an interloper.<sup>4</sup> The existence of such goals, however, explains only why an insider might value property, in this case shares, more highly than an outsider would; it does not explain why the encumbrance is necessary. Presumably, if the insider places the highest value on shares or other property, he will buy them when they are offered for sale. Underlying this rationale, then, must be a further argument about bargaining breakdown. Fully spelled out, the argument is that an insider may place a high idiosyncratic value on a property and that, absent the insurance provided by a right of first refusal, such value could be lost in a failed negotiation.<sup>5</sup>

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<sup>4</sup>See EASTERBROOK & FISCHER, *supra* note 3, at 228-29; O'NEAL & THOMPSON, *supra* note 3, § 7.02; Joseph Jude Norton, *Adjustment and Protection of Shareholder Interests in the Closely-Held Corporation in Texas*, 39 SW. L. J. 781, 804. These arguments are described more fully *infra* Part III.A.

<sup>5</sup>This argument is advanced in Kahan, *supra* note 3, and is more fully developed *infra* Part III.

Although helpful, the bargaining-breakdown explanation is not fully persuasive. The second aim of this Article is to rebut this justification by demonstrating that equally effective insurance against bargaining breakdown can be provided at lower cost through an instrument that I call a commitment to auction.

*3. Suggest that rights of first refusal are primarily motivated by a desire to inhibit exit.*

Having rejected the bargaining-breakdown-insurance hypothesis as inadequate, my third goal is to develop alternative explanations for the persistence of rights of first refusal. I argue that most rights of first refusal spring from a desire not just to ensure that, if *A* sells, *B* gets an opportunity to purchase the property, but from a desire to inhibit *A* from selling in the first place. In other words, the selection of the right of first refusal over the commitment to auction must be explained by a desire to restrain alienability and preserve the status quo. Although credible in the context of close corporations and other co-venturing relationships, this justification does not make sense in all circumstances in which the right of first refusal is adopted. In contexts in which inhibiting exit is an unpersuasive justification, however, the right of first refusal generally carries a lower incremental cost, and the instrument's persistence may be partially explained by network externalities.

Part I describes the uses of rights of first refusal, their variations, and alternatives, as well as the assets typically encumbered and the participants usually involved. Because the terminology associated with these restrictive devices is not used consistently, one of the purposes of this Part is to closely identify the "true" right of first refusal that will be the focus of this Article. Part II analyses the cost of the right of first refusal grant. In this Part, I argue that contracting parties who encumber assets with rights of first refusal reduce the expected gains of

third parties considering bidding on the assets. This phenomenon, I argue, deters bidders and reduces the expected realization on the sale of such property.

Part III develops the bargaining-breakdown justification. I argue that the potential for high insider idiosyncratic value in relationships in which rights of first refusal are typically found make these relationships particularly susceptible to bargaining breakdown. This finding, however, only justifies the provision of some insurance; it does not necessarily support the creation of a right of first refusal. Accordingly, Part IV undercuts this justification as it demonstrates that the adoption of a commitment to auction the encumbered property provides the same insurance at a lower cost. Like a right of first refusal, a commitment to auction avoids the possibility of lost insider idiosyncratic value through failed negotiations, but third-party bidders and, thus, the expected realization on the sale of the property are not as adversely affected by the use of the auction device.<sup>6</sup>

The close corporation model is the focus of Part V. There, I argue that co-venturers often would wish to inhibit the exit of members as well as to veto new additions, and that the relatively harmless-looking right of first refusal has become the legally acceptable tool of choice for achieving this goal. Part VI, however, suggests that inhibition of exit does not adequately explain all rights of first refusal, and this Part develops other explanations, chiefly network

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<sup>6</sup>This statement highlights the quandary faced by the parties considering the adoption of a right of first refusal. The contract that may incorporate such a right is often written years or decades before a sale is contemplated. At the time of contract formation the parties cannot know whether at the time of sale the rightholder or a third party will place the higher value on the property, but in order to maximize the pie the contracting parties must be concerned about both scenarios.

Although an arbitrary result of utilizing the right of first refusal as a baseline, throughout this Article the potential loss of higher third-party value is considered a cost to the contracting parties, while the retention of high insider value is considered a benefit.

externalities, to fill the gap. The implications of the analysis are briefly reviewed in Part VII. Given the presumption of efficient contracting in the private sector, the focus of this Part is on statutory grants of rights of first refusal.

## I. A DESCRIPTION OF RIGHT OF FIRST REFUSAL PRACTICE

This Part describes the right of first refusal in very general terms, distinguishes the instrument from an option, and touches upon several alternative instruments. The range of assets encumbered, the participants involved, and the sources of the right also are described.<sup>7</sup>

### A. An Overview of the Right of First Refusal, Variations, and Alternatives

*1. A Typical Right of First Refusal.* The following arrangement is typical of the classic right of first refusal: The owner and lessor of a property grants to the lessee a right to match the terms of and preempt any sale of the property negotiated between the owner and a potential third-party buyer during the term of the lease. This preemption right essentially allows the lessee to step into the shoes of the potential buyer and make the purchase. If, after receipt of notice and within a specified time, the lessee elects not to exercise the right, the owner and third-party buyer have a fixed term in which to execute the transaction. If the lessee elects not to exercise and, for some reason, the sale is not consummated with the third party or is not completed within the specified period, the right of first refusal is reactivated and the lessee must again be given notice and the right to preempt before the property may be sold. Because the right of first refusal could be circumvented by the owner's negotiation of a swap of the property for a unique property

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<sup>7</sup>For further description and analysis of rights of first refusal, see CORBIN, *supra* note 2, § 11.3. A large number of cases involving garden-variety rights of first refusal are collected in this reference. In the descriptions that follow I have limited my citations to the more unusual applications of the instrument.

owned by the third-party buyer, the contract providing the right of first refusal grant often will confine the owner to negotiating a sale for cash.

The right of first refusal device apparently serves two purposes. First, it provides some security to the lessee. Although the sale of the property would not disrupt the lease, the lessee may care about the identity of his lessor. Under this arrangement, if the owner decides to sell, the lessee will at least be given the opportunity to purchase. Second, although the right of first refusal may restrict the owner, she is not locked in to ownership of the asset for the full term of the lease.

**2. Diversity in Right of First Refusal Terms.** A “right of first refusal” is simply a fancy name for a small bundle of contract terms. As such, the applications and variations of the right are seemingly infinite. In contrast to the grant of a right to purchase, the right of first refusal may be used to grant a preemptive right to sell,<sup>8</sup> a right to lease,<sup>9</sup> a right to employ,<sup>10</sup> or a right to be employed.<sup>11</sup> The right of first refusal may be granted for a limited duration, as in the right to preemptively purchase during the term of a lease, or, subject only to certain rules barring perpetuities, the right may be perpetual, as in the case of a shareholders’ agreement that grants a

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<sup>8</sup>*See, e.g.,* Hyperbaric Oxygen Therapy Sys., Inc. v. St. Joseph Medical Ctr. of Fort Wayne, Inc., 683 N.E.2d 243 (Ind. Ct. App. 1997) (right of first refusal to sell medical equipment).

<sup>9</sup>*See, e.g.,* Ellwest Stereo Theaters, Inc. v. Davilla, 436 So. 2d 1285 (La. Ct. App. 1983) (right of first refusal to lease commercial property).

<sup>10</sup>*See, e.g.,* American Broadcasting Cos. v. Wolf, 430 N.Y.S.2d 275 (N.Y. App. Div.), *appeal dismissed*, 413 N.E.2d 1173 (N.Y. 1980), *aff’d*, 420 N.E.2d 363 (N.Y. 1981) (right of first refusal on services of sportscaster).

<sup>11</sup>*See, e.g.,* Russell v. District of Columbia, 747 F. Supp. 72 (D.D.C. 1990), *aff’d*, 984 F.2d 1255 (D.C. Cir. 1995) (hospital employees given right of first refusal on other positions within the District).

close corporation a right of first refusal on any sale of shares by the shareholders. Generally, the right of first refusal is granted as one element of a larger transaction -- in my first example the right of first refusal was incidental to the lease of property. It is conceivable, however, that parties might contract solely for the grant of the right of first refusal.

**3. *Fixed Price Rights of First Refusal.*** In my example involving the right of first refusal held by the lessee, the contract specified that the right to preempt would be at the price negotiated between the owner and the third-party buyer. This, indeed, is the standard approach adopted by contracting parties, and it is an intuitively appealing arrangement, as the owner is required to develop an executable deal and the price is assumed to be at or near market. An alternative to this arrangement is the grant of a right of first refusal at a fixed price. Although rarely seen today, some contracts have specified that if the grantor chose to sell parcel *X* within a certain period, the grantee would have the right to purchase the parcel for \$*Y*.<sup>12</sup> Because a parcel would undoubtedly be worth something other than \$*Y* at the time a right is triggered, such a grant generally would either be worthless to the grantee (when the market price is below \$*Y*) or would prevent the grantor from selling or cause her considerable loss if forced to sell (when the market price is above \$*Y*). Thus, the rarity of this variation is not surprising.

**4. *Distinguishing Rights of First Refusal from Options.*** Although often associated with options, the right of first refusal is not a true option. The holder of an option to purchase, for instance, has a unilateral right to trigger the purchase at the option price during the term of the

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<sup>12</sup>See, e.g., *Smith v. Estate of La Tray*, 555 N.Y.S.2d 968 (N.Y. App. Div. 1990).

option.<sup>13</sup> The holder of the right of first refusal, by contrast, has only a contingent option. Contingent upon the grantor's decision to sell, the right of first refusal grantee has an option to purchase.<sup>14</sup>

**5. Alternatives to the Right of First Refusal.** The right of first refusal is a means of dealing with foreseeable, but unpredictable, changes in business relationships. The option, discussed above, is an alternative mechanism for managing a changeable environment, and the right of first offer is another. The right of first offer is essentially a right of first refusal in reverse. Its use can be demonstrated by substituting a right of first offer for the right of first refusal in the lease example: The lessor grants the lessee a right of first offer. If the lessor decides to sell the property during the term of the lease, perhaps after preliminary discussions with potential buyers, the lessee will be given notice and a specified period during which to make an offer to purchase. The owner may accept the offer or may, within a specified period, sell to a

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<sup>13</sup>Generally an option price is fixed or is objectively determinable by reference to a public market.

<sup>14</sup>One frequently litigated question, although not one of importance to this analysis, is whether, assuming that the contract is silent on this point, the delivery of notice to the right of first refusal grantee triggers a unilateral right to preempt during the term allotted for exercise of the right, in other words, whether the right of first refusal matures into an actual option for the exercise period, or whether the grantor may change her mind and revoke the "option" during the exercise period if the grantee has not yet noticed his intention to preempt. The case results on this question are mixed. *Compare* CORBIN, *supra* note 2, § 11.3, at 470-71 (The "owner's receipt of an offer and the good-faith decision to accept it . . . 'triggers' the right of first refusal that 'ripens' into an option. The option then can be exercised like any other option contract.") *with* LIN Broadcasting Corp. v. Metromedia, Inc., 542 N.E.2d 629, 633-35 (N.Y. 1989) (the right of first refusal is not converted into an option by the owner's offer to sell and may be revoked prior to acceptance by the rightholder).

It is important to recognize that the labels applied by the parties do not always mirror the economic reality of the instruments involved. A true option that gives the holder a unilateral right to trigger is often labeled a right of first refusal, while a true right of first refusal that grants the holder only a contingent option is sometimes called a first option.

third party. However, the owner may not sell to a third party for a price less than that offered by the lessee.<sup>15</sup>

Another alternative to employing a right of first refusal is the adoption of a commitment to negotiate. Often seen in the employment context, the commitment to negotiate specifies a period during which each party to the contract commits to negotiate exclusively with the other(s) and in good faith. If time is critical, the existence of an exclusive negotiating period puts some pressure on the parties to reach agreement. The value of an entertainer whose services are so encumbered, for example, may be eroded if he is kept off the market for several months. Property transactions, however, often are less time sensitive, and a commitment to negotiate may only defer a transaction with a third party at nominal cost to the owner.

## **B. Assets Encumbered by Rights of First Refusal**

*1. Real Property.* Real property may be the most common subject of rights of first refusal.<sup>16</sup> A survey of right of first refusal cases litigated in any year will reveal that the large majority involves undeveloped land, residential property, or commercial property. Moreover, almost all of these cases will involve the grant of a preemptive right to purchase (as opposed to a right to lease, or a right to sell). The range of commercial assets encumbered by rights of first refusal is quite diverse. Commercial assets involved in litigated cases from 1990, for instance,

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<sup>15</sup>A further variation on this arrangement is a right of first offer at an appraised price. Under this scheme, an owner wishing to sell must have the property appraised and must provide the rightholder an opportunity to purchase at the appraised price. If the rightholder declines, the owner may proceed to sell the property unencumbered. As in the case of options, true rights of first offer are occasionally labeled rights of first refusal. One must look beyond the label to the economic reality to accurately classify and analyze the instrument.

<sup>16</sup>See CORBIN, *supra* note 2, § 11.3, at 469.

included an automotive repair shop,<sup>17</sup> a hardware store,<sup>18</sup> a gasoline service station,<sup>19</sup> an oil storage terminal,<sup>20</sup> and a natural gas pipeline.<sup>21</sup>

**2. Securities.** Another important category of encumbered assets is corporate securities, and, in particular, the shares held by the owners of close corporations. Typically, the close corporation charter or bylaws will provide that the corporation and/or other shareholders will have a right of first refusal on the sale of any shares by any owner. Although these arrangements rarely result in litigation, it has been reported that over half of U.S. corporations restrict the transfer of shares<sup>22</sup> and that “option” agreements, including rights of first refusal, are the most common transfer restriction.<sup>23</sup> Occasionally cases involving securities arise outside of the close corporation shareholder context. In one notable case a large firm granted a key manager a right of first refusal on the shares of a subsidiary corporation.<sup>24</sup>

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<sup>17</sup>See *Roy v. George W. Greene, Inc.*, 563 N.E.2d 215 (Mass. 1990).

<sup>18</sup>See *Stone v. W. E. Aubuchon Co.*, 562 N.E.2d 852 (Mass. App. Ct. 1990).

<sup>19</sup>See *Dege v. Milford*, 574 A.2d 288 (D.C. 1990).

<sup>20</sup>See *Koch Indus., Inc. v. Sun Co.*, 918 F.2d 1203 (5th Cir. 1990).

<sup>21</sup>See *West Tex. Transmission, L.P. v. Enron Corp.*, 907 F.2d 1554 (5th Cir. 1990), *cert denied*, 499 U.S. 906 (1991).

<sup>22</sup>See O’NEAL & THOMPSON, *supra* note 3, § 7.02.

<sup>23</sup>See *id.* § 7.05.

<sup>24</sup>See *Pincus v. Pabst Brewing Co.*, 893 F.2d 1544 (7th Cir. 1990).

3. **Commercial Products.** Commercial products, such as the weekly or monthly production from a chemical plant, are occasionally subjected to rights of first refusal.<sup>25</sup> The price terms in such agreements may be fixed, and, given the immediacy of sale<sup>26</sup> and the fact that the grantee knows roughly when the owner will be selling, such rights of first refusal resemble traditional options.

4. **Employment.** The term “right of first refusal” also is used in employment contracts. Typically, the employee and employer will agree to a fixed-term contract. In addition, the contract will provide that for a certain term beyond the expiration of the contract, perhaps three months, the employer will have a right of first refusal to match any offer agreed to for future employment between the employee and another employer. Often the right of first refusal is accompanied by a commitment between the employee and employer to negotiate in good faith during that three-month term or for some lesser period. If the employee has decided she would prefer to work elsewhere, however, the right of first refusal in this situation simply serves as a non-compete clause for its duration.<sup>27</sup>

### C. Participants in Right of First Refusal Agreements

1. **Co-Venturers.** Right of first refusal agreements can be classified as reciprocal or unilateral depending on the relationship between the participants. Co-venturers often create agreements in which each participant reciprocally grants and receives first-refusal rights to and

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<sup>25</sup>See, e.g., *Madison Indus., Inc. v. Eastman Kodak Co.*, 581 A.2d 85 (N.J. Super. Ct. App. Div. 1990).

<sup>26</sup>Normally the owner’s storage capacity will be limited and regular offtake will be necessary.

<sup>27</sup>See, e.g., *American Broadcasting Cos. v. Wolf*, 430 N.Y.S.2d 275 (N.Y. App. Div.), *appeal dismissed*, 413 N.E.2d 1173 (N.Y. 1980), *aff’d*, 420 N.E.2d 363 (N.Y. 1981).

from the others. The close corporation example noted above is typical and demonstrates that the organization may *also* hold rights or it may hold rights *instead* of the participants. In either case, however, the grants are roughly reciprocal. A corporate entity is by no means necessary to generate a reciprocal grant of first-refusal rights, however. Co-owners of land, a building, or even a horse may grant reciprocal rights of first refusal without a corporate or even a partnership structure.<sup>28</sup> Depending on the agreement, or a court's interpretation if the agreement is lacking, these rights may run with the asset and be transferable, or they may be personal rights that vanish on transfer.<sup>29</sup> In the close corporation context, the rights are usually specified in the charter or bylaws and are perpetual. Therefore, if shares are sold to a third party, the new co-venturer will be in the same position with regard to rights of first refusal as was her predecessor.<sup>30</sup>

**2. *Unilateral Rights of First Refusal.*** The lessor/lessee example that began this Part is a good example of a one-way or unilateral grant of a right of first refusal. Such unilateral grants are typically seen in lease and franchise agreements, in agreements between different classes of security holders of a corporation, in agreements between employers and employees, and in

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<sup>28</sup>*See* Guggenheim v. Commissioner, 46 T.C. 559 (1966) (undivided ownership interests in a thoroughbred racehorse subjected to rights of first refusal).

<sup>29</sup>*Compare* Sherwood Ford, Inc. v. Ford Motor Co., 860 F. Supp. 659 (E.D. Mo. 1994) (under Missouri law, right of first refusal is a covenant that runs with the land) *with* Todd v. United States, 617 F. Supp. 253 (W.D. Pa. 1985) (covenant granting individuals right of first refusal was personal and terminated on their deaths). Occasionally, rights of first refusal that run with an asset are held to violate the rule against perpetuities. *See, e.g.,* Adler v. Simpson, 610 N.Y.S.2d 351 (N.Y. App. Div. 1994).

<sup>30</sup>If rights of first refusal are codified in a shareholders' agreement in addition to or in place of codification in the charter or bylaws, that agreement should provide for new shareholders to become parties to the agreement after valid transfers occur. *See* O'NEAL & THOMPSON, *supra* note 3 § 7.35.

agreements between product producers and purchasers. In the lease and franchise case, the right of first refusal generally will run only for the lease or franchise term. The employment right of first refusal, as noted above, typically extends only for a short period beyond the length of the employment contract, and the producer/purchaser arrangement also is normally short term. The grant of a right of first refusal by one class of security holders to another exemplifies an instance in which a unilateral right of first refusal may be long-running.

#### **D. Sources of First Refusal Rights**

Thus far, each right of first refusal example discussed has arisen by way of agreement between the parties, and contract is the primary source of first refusal rights. Increasingly, however, first-refusal or similar rights are being created by statute. Such rights are frequently litigated, and the statutory grant of first-refusal rights raises several concerns that will be addressed subsequently. For present purposes it is enough to outline the workings of several typical statutes:

The Petroleum Marketing Practices Act<sup>31</sup> regulates the termination of service station franchises and provides that a distributor wishing not to renew a franchise agreement in order to sell the premises first must offer to sell the station to the franchisee or offer the franchisee a right of first refusal on the third-party purchaser's offer. A Florida statute requires an owner of a mobile home park who wishes to offer the park for public sale to provide the homeowners' association a right of first refusal.<sup>32</sup> A number of states have enacted statutes requiring apartment building owners who wish to convert to condominium status to offer the units to the tenants in

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<sup>31</sup>15 U.S.C. § 2802 (1997).

<sup>32</sup>See FLA. STAT. ANN. § 723.071 (West 1997).

advance and, if a tenant declines to purchase, forbidding the owner from selling that unit for a lower price for a specified period.<sup>33</sup> Finally, a number of midwestern states have passed statutes that provide the former owner of a foreclosed farm a right of first refusal on the subsequent sale of the farm by a lending institution.<sup>34</sup>

## **II. THE IMPACT OF THE RIGHT OF FIRST REFUSAL ON NEGOTIATION AND VALUE -- WHY THE INSTRUMENT IS COSTLY FOR THE CONTRACTING PARTIES**

The previous Part has suggested and Part III will demonstrate more rigorously that a right of first refusal provides value to the parties creating it. If, as it is sometimes implied, the grant costs the contracting parties little or nothing and simply involves a transfer from grantor to grantee, then the instrument would be unambiguously valuable. This Part demonstrates, however, that the parties to the right of first refusal do incur a joint cost. In providing for the right, the contracting parties decrease the expected realization from the sale of the property.

Section A briefly reviews the literature on this subject and finds that little attention has been paid to the net cost of rights of first refusal. Section B introduces the economic analysis by discussing the search and negotiation costs that a third party considering making a bid for a property must weigh against his expected gain on the purchase, as well as other factors that affect the third party's willingness to bid against a right of first refusal. Section C compares the negotiating dynamics with and without the right of first refusal and demonstrates that a third party's expected gain from bidding is reduced by the encumbrance. Section D explains that the

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<sup>33</sup>*See, e.g.*, VA. CODE ANN. § 55-79.94 (Michie 1997).

<sup>34</sup>*See, e.g.*, IOWA CODE ANN. § 654.16 (West 1997).

impact on potential bidders translates into reduced expected value for the parties to the right of first refusal contract.

### A. The Literature on the Costs of Rights of First Refusal

To my knowledge no one has conducted an economic analysis of the right of first refusal that fully considers the impact on all of the parties to the transaction. Marcel Kahan has analyzed the transfer of wealth from the grantor to the rightholder, but he did not evaluate the net cost to the contracting parties that follows from the instrument's deterrence of potential third-party bidders. Kahan did, however, suggest that right of first refusal agreements produce negotiating, drafting, and dispute related costs.<sup>35</sup>

Other commentary and cases dealing with the subject recognize that the right of first refusal is a valuable and enforceable right of the grantee<sup>36</sup> that must be supported by consideration.<sup>37</sup> However, these sources do not consider whether the value to the rightholder is offset equally, or more, or less, by the cost to the grantor. If anything, the commentators tend to de-emphasize the significance of the right of first refusal.<sup>38</sup> Farnsworth notes that the right of

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<sup>35</sup>See Kahan, *supra* note 3.

<sup>36</sup>See, e.g., *American Broadcasting Cos. v. Wolf*, 430 N.Y.S.2d 275, 281 (N.Y. App. Div.), *appeal dismissed*, 413 N.E.2d 1173 (N.Y. 1980), *aff'd*, 420 N.E.2d 363 (N.Y. 1981) (A right of first refusal is a “valuable right which has enjoyed the protection of the courts.”).

<sup>37</sup>See, e.g., FARNSWORTH, *supra* note 3, at 288.

<sup>38</sup>Exceptions to this rule are seen principally in articles questioning the wisdom of statutory grants of rights of first refusal. See, for example, Lawless, *supra* note 3, at 1063-65, in which the author argues that statutes granting farmers rights of first refusal on foreclosed farm property will, like other procedural debtor relief measures, raise interest rates and tighten credit for farmers generally. This situation, however, involves a nonconsensual transfer, and the author's point is not to determine whether the cost to the creditor is offset by the gain to the debtor. In the past courts have occasionally invalidated rights of first refusal as unreasonable

first refusal is less advantageous to the holder than an option because the right of first refusal cannot be unilaterally exercised.<sup>39</sup> Corbin states that in comparison with the grant of an option, a right of first refusal, at least for a definite period, “operates very little, if any, as a restraint on alienation by [the owner]. . . . Rather than restraining alienation, the right enhances it by providing two buyers when property is sought to be sold.”<sup>40</sup> We will see, however, that this characterization of the right of first refusal as innocuous or even pro-alienation is far from accurate.

### **B. Factors Affecting an Outsider’s Willingness to Bid Against a Right of First Refusal**

A third party considering making a bid for a property offered for sale weighs the expected payoff -- the probability of success and gain from a successful bid -- against the costs involved in making that bid. As will be demonstrated below, the introduction of a right of first refusal adversely affects the third party’s expected payoff. The costs faced by the third party are not seriously impacted by the existence of the right of first refusal, but these costs do relate to the relative uniqueness of the property in question. The uniqueness of the property also may have an impact on an insider’s informational advantage and the possibility of insider idiosyncratic value, both of which impact the third party’s expected payoff. This Section merely introduces the

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restraints on alienation. *See* notes 109-10 *infra* and accompanying text. Obviously these courts did not believe the right of first refusal to be insignificant.

<sup>39</sup>*See* FARNSWORTH, *supra* note 3, at 288. *See also* Pincus v. Pabst Brewing Co., 893 F.2d 1544, 1549 (7th Cir. 1990) (“[A] binding right of first refusal can be a powerful instrument. Yet a right of first refusal to buy something is more contingent than an option to buy the same thing and is therefore less valuable.”).

<sup>40</sup>CORBIN, *supra* note 2, § 11.3 at 484-85.

factors affecting an outsider's willingness to bid against a right of first refusal. Their influence will be felt throughout the balance of this Article.

*1. Search and Negotiation Costs.*<sup>41</sup> A potential buyer alerted to an opportunity to purchase an asset faces several costs. First, the purchaser must collect information and evaluate the merits of the asset in order to arrive at a valuation. These costs are commonly referred to as search costs. Second, the buyer incurs negotiation costs in attempting to reach agreement with the seller. Together, these search and negotiation costs constitute a portion of the buyer's transaction costs. Obviously if the buyer is successful there will be other transaction costs, but for my purposes it is sufficient to focus upon the buyer's search and negotiation costs. In deciding whether to enter the fray, a potential buyer will weigh her estimate of the search and negotiation costs against her estimate of the potential gain from the purchase. Although costs incurred become sunk as the process continues, the buyer will continue to evaluate the estimated future costs and gains and may at any time withdraw from the contest.

The buyer's search costs are related to the pricing transparency and fungibility of the property. Widely traded, publicly held securities are costlessly valued by looking at the market. An undeveloped plot of city property or a standard apartment building may be valued relatively quickly and cheaply. However, a unique commercial property or an unusual piece of land may be more difficult and costly to value, while the shares of a closely held, thinly traded corporation will be very difficult and costly to value.

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<sup>41</sup>The impact of the cost of search and expected gains on the optimum level of consumer search is discussed generally in EDWIN MANSFIELD, MICROECONOMICS THEORY/APPLICATIONS 112 (5th ed. 1985).

The wider variation in the potential valuation of unique property also raises the expected negotiation costs of the outside buyer. Again, it takes very little time for a seller and buyer to reach terms on the sale of publicly traded stock, whereas the simple act of negotiation will be costly with regard to thinly traded close corporation shares.

**2. Insider Idiosyncratic Value.** In almost every case in which a right of first refusal exists, the potential outside buyer should recognize that an insider may place idiosyncratic value on the property. In the close corporation context, for example, the insiders may value maintaining family ownership and control,<sup>42</sup> while the lessee of a building faces relocation costs and loss of goodwill if ousted by a new owner at the end of the current lease. The uncertainty created by the specter of potential insider idiosyncratic value reduces the outsider's expected payoff and generally lowers an outsider's interest.

Intuition suggests that the potential for idiosyncratic value correlates roughly with uniqueness. Close corporation shares are quite unique and have a high potential for insider idiosyncratic value. Commercial property tends to be less unique and generally carries less idiosyncratic value.<sup>43</sup>

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<sup>42</sup>Factors contributing to idiosyncratic value for the insiders of a close corporation are discussed in EASTERBROOK & FISCHER, *supra* note 3, at 228-29; O'NEAL & THOMPSON, *supra* note 3, § 7.02; and Norton, *supra* note 4, at 804. These factors are discussed more fully *infra* Part III.A.

<sup>43</sup>Relocation costs and loss of goodwill create idiosyncratic value for the lessee of even the most fungible property. Where these effects are significant, however, one would expect the lessee to protect that value through options to extend the lease, as rights of first refusal alone provide no security against termination at the end of the lease. Renewal options would be enforceable against a successor landlord, of course. In any event, although insider idiosyncratic value is an important element of the analysis, it is not critical whether the incidence of such value is random or correlates with uniqueness.

3. *Insider Informational Advantage.* In a bidding competition between an outsider and an insider, the insider generally will have a significant informational advantage. The magnitude of this advantage relates to the fungibility and transparency of the property. For example, the close corporation participant has much better information with which to evaluate the shares offered by his departing partner. Even if disclosure to the third party is exhaustive, the insider's feel for the firm puts him at an advantage.<sup>44</sup> By contrast, the co-owner of a share of Microsoft has no advantage over an outside bidder, and the co-owner of a fungible piece of real estate has only a limited information advantage.

The existence of an insider with an informational advantage affects the outsider's expected return and willingness to enter the bidding. If the better informed insider knows that the true property value is higher than the outsider believes, the insider will tend to buy. In the reverse situation, the insider will refrain. The net result should be that the informationally disadvantaged outsider tends to succeed when true value is low and to fail when true value is high.<sup>45</sup>

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<sup>44</sup>This advantage is similar to that enjoyed by the insider of a public corporation trading in his own stock. Even if the insider refrains from trading on material, nonpublic information, he still may profit by trading on "diffuse insight into business prospects." See Reinier Kraakman, *The Legal Theory of Insider Trading in the United States*, in EUROPEAN INSIDER DEALING: LAW AND PRACTICE 40, 48 (Klaus J. Hopt & Eddy Wymeersch eds., 1991).

<sup>45</sup>The outsider's position in this situation is analogous to that of an honest player in a dishonest card game or, as some have argued, to that of an uninformed shareholder trading in a market dominated by insiders trading on material, nonpublic information. See *id.* at 49 ("insider trading reduces the effective return on [outsiders'] investments"). Even in the absence of an inside contestant, an outside bidder faces an information disadvantage in dealing with an opportunistic seller of unique property in an isolated negotiation. The knowledgeable seller may opportunistically choose to sell bad assets and retain good ones, and the outside buyer can not distinguish as effectively between the two. The difference in the right of first refusal context is that generally the seller can assure the outsider that he is selling for external reasons, rather than

In sum, the expected search and negotiation costs faced by the outsider are greater with respect to unique property as is the outsider's information disadvantage relative to competing inside bidders. At the same time the higher variance in potential value causes the outsider's return to be less certain. Given the additional possibility of insider idiosyncratic value, the outside bidder faces serious obstacles to winning a contest to purchase relatively unique property, even if no right of first refusal exists.<sup>46</sup>

### **C. The Impact of a Right of First Refusal on Negotiation Strategy and Outcome**

In this Section, I focus on the options available to and the optimal strategy selected by a third party who is bidding on property encumbered by a right of first refusal. In so doing, I compare that position to the one that would be enjoyed by such a bidder were the property unencumbered, and I examine the outcomes for each party to the negotiations. At this stage, for simplicity, I assume that the seller of an unencumbered property would auction that property to the highest bidder. I demonstrate that the direct result of the encumbrance is to reduce the third party's expected gain from bidding.<sup>47</sup>

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simply disposing of lemons. *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. FIN. 488-500 (1970).

<sup>46</sup>The number of competing outside bidders also has an impact on any particular third party's willingness to enter the competition. More importantly for my analysis, however, we will see in the following sections that the number of potentially interested third-party buyers has an important effect on bidding dynamics and the contracting parties' decision to create a right of first refusal. Although many elements, including price, influence the level of outside interest, all else being equal, generally there will be fewer outside buyers interested in non-fungible, non-transparent property.

<sup>47</sup>For general insight into negotiation strategy and optimization, see HOWARD RAIFFA, *THE ART AND SCIENCE OF NEGOTIATION* (1982).

*1. A First Cut.* Suppose the owner of an encumbered property desires to dispose of his property to either the holder of a right of first refusal (the rightholder) or a single third-party buyer (the bidder). Assume that the seller must sell the property, so that the seller's reservation price does not come into play. Suppose that the bidder suspects that the value placed on the property by the rightholder,  $V_{RH}$ , is near the value placed on the property by the bidder,  $V_B$ .<sup>48</sup> Under the terms of the right of first refusal, the bidder must negotiate a price with the seller which will be transmitted to the rightholder, who may match the offer and purchase himself or decline and allow the bidder to consummate the purchase. Because the seller's reservation price is not at issue, the "negotiation" between the seller and the bidder boils down to the bidder making a single offer that maximizes her expected gain.

We can be sure that the bidder's offer,  $O_B$ , will be less than  $V_B$ , since a successful offer at the bidder's value (or higher) would yield no payoff for the bidder. Three outcomes are then possible. First, the bidder will succeed if  $O_B$  is greater than  $V_{RH}$ . Second, the bidder will lose and the property will be misallocated to the lesser-valuing rightholder if  $O_B$  is less than  $V_{RH}$  and  $V_{RH}$  is less than  $V_B$ . In other words, if the bidder is unlucky enough to have had the higher value but to have discounted her bid below the value of the rightholder, she will lose despite her higher valuation. Third, the bidder will lose the bidding, but there will be no misallocation, when  $V_{RH}$  is greater than  $V_B$ .

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<sup>48</sup>This example supposes that while  $V_{RH}$  may in fact be higher or lower than  $V_B$  there is no bias between the two values. Given the previous discussion of insider idiosyncratic value, this may seem an odd assumption. The third party, however, may also bring value to the table. Perhaps the bidder is a turnaround expert or brings a needed infusion of cash. Although the bidder's value may not be idiosyncratic (it may be shared by other possible third-party bidders), it may be as large or larger than  $V_{RH}$ . In any event the conclusions reached do not depend on a lack of bias between  $V_{RH}$  and  $V_B$ .

Alternatively, suppose that there had been no right of first refusal and that the seller had conducted a progressive auction between the bidder and the rightholder.<sup>49</sup> In the auction scenario, assuming suitably small increments, the bidder succeeds if and only if  $V_B$  is greater than  $V_{RH}$ .

How did the introduction of the right of first refusal affect the fortunes of the three participants? To make matters concrete assume that  $V_B$  is 100 and that  $O_B$  is 96.<sup>50</sup> If  $V_{RH}$  is 90, then the bidder would have won an auction at 90 (or just over depending on the increments). Under the right of first refusal, the bidder would win at her bid of 96, so the bidder is worse off by 6 due to the right of first refusal. The rightholder is indifferent; he would have lost either way. The seller is better off by 6 in the right of first refusal scenario.

Now, assume that  $V_{RH}$  is 98. Under the right of first refusal, the rightholder matches the bidder's offer and wins at 96. In an auction the bidder, whose value is 100, would have won at 98. So compared with the auction result, the rightholder gains 2 (98 value minus 96 purchase price) by way of the right of first refusal, the seller loses 2 (sale at 96 versus sale at 98), and the bidder loses 2 (loss in right of first refusal versus success and profit of 2 in the auction). Unlike the first scenario, here there is a net loss to the three parties of 2 due to the misallocation of the property. That loss can be eliminated, of course, if the rightholder subsequently can resell the

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<sup>49</sup>I will continue to use the label "rightholder" for consistency while recognizing that in this scenario the rightholder has no rights beyond those shared by the third-party bidder.

<sup>50</sup>This offer discount (offer of 96 vs. value of 100) approximates the optimum offer of the bidder given certain assumptions about the rightholder's range of possible values, as we will see below. At this point, however, the selection of these figures should be considered merely illustrative. Directionally, the results that follow hold for any discount selected by the bidder and any range of rightholder values.

property to the bidder. Notice, however, that even if no resale is possible, the parties to the right of first refusal contract, the seller and the rightholder, are indifferent in sum.

Finally, assume that  $V_{RH}$  is 102. Under the right of first refusal, the rightholder again matches  $O_B$  and wins at 96. In an auction the rightholder would have prevailed at 100. So compared with the auction result, the rightholder gains 4, the seller loses 4, and the bidder, who would have lost either way, is indifferent.<sup>51</sup>

The following table summarizes the results of this example:

<u>Outcome Under Right of First Refusal Compared With Progressive Auction</u> (With $V_B=100$ , $O_B=96$ )				
$V_{RH}$	<u>Rightholder</u> <u>Gain/Loss</u>	<u>Seller</u> <u>Gain/Loss</u>	<u>RH + S</u> <u>Gain/Loss</u>	<u>Bidder</u> <u>Gain/Loss</u>
90	0	+6	+6	-6
98	+2	-2	0	-2
102	+4	-4	0	0

The following conclusions may be drawn from this highly simplified analysis. Although there is often a shift in value from the seller to the rightholder and the property is sometimes allocated to the lesser valuing rightholder, the parties to the right of first refusal contract, in sum,

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<sup>51</sup>The transaction costs of the various parties have been ignored in the foregoing analysis. At the time of bidding these costs are sunk and will not affect bidding behavior. Moreover, as I demonstrate elsewhere in the Article, the parties' transaction costs are not significantly affected by the bidding process utilized, and thus transaction costs have no significant impact on the relative outcomes. See *supra* Part II.B for analysis of the bidder's transaction costs and *infra* Part IV.B for discussion of the rightholder's and seller's costs.

are never worse off due to the existence of the right. As long as there is only one third-party buyer involved, an auction will not allow the seller and the rightholder to extract any of the bidder's value in excess of the rightholder's value. Thus, in this simplified, one-buyer universe the seller and the rightholder appear to suffer no net harm. The bidder, of course, is adversely impacted. The right of first refusal "negotiation" is loaded against her. The problem for the seller and the rightholder is that the adverse impact on the bidder dissuades third parties from participating, and, as we shall see, ultimately this creates a cost for the parties to the right of first refusal contract.

**2. Detailed Analysis of the Bidder's Position.** Let us look at the bidder's position, optimum strategies, and expected outcomes in the auction and right of first refusal scenarios more carefully. Suppose again that  $V_B$  is 100 and that the bidder doesn't know the rightholder's value but estimates that the rightholder's probable value is normally distributed with a mean of 100 and standard deviation of 5.<sup>52</sup> In an auction the bidder's strategy is simple; she raises her bid following each successively higher bid of the rightholder until she wins or reaches her indifference point. In this case, the bidder is learning something about the rightholder's value with each successive bid. If the probability distribution of the rightholder's value is indeed normal with a mean of 100, each participant has a 50% chance of winning the auction. The bidder's expected gain can be calculated by determining the bidder's probability of success (and, if successful, the gain) at each possible bid level in the auction up to the bidder's indifference

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<sup>52</sup>Obviously a unique rightholder will place a unique value on a unique property. But a competing bidder attempting to estimate the outcome of an auction or to calculate the optimum bid and expected outcome in a right of first refusal situation can only estimate, probabilistically, her opponent's valuation of the property. The decision whether to incur transaction costs and proceed can only be based on such a probabilistic estimation.

point. As I demonstrate in the Appendix, the bidder's expected gain in this scenario is equal to 0.4 times the standard deviation of the rightholder's probability distribution, or, in this example, 2.0.<sup>53</sup>

Now assume all the same values for  $V_B$  and the mean and standard deviation of  $V_{RH}$ , but assume that the bidder is faced with a right of first refusal and must formulate a bid that will maximize her expected gain. In this situation the bidder loses the information generated by the auction. As I demonstrate in the Appendix, the bidder maximizes her expected gain by bidding at the rightholder's mean value less .75 standard deviations, in this case by bidding at 96.25.<sup>54</sup> At this optimum bid, there is a 23% chance that the rightholder's value will be less than 96.25, that the rightholder will not exercise his right, and that the bidder will consummate the transaction. The bidder's expected return, however, falls from 2.0 in the auction scenario to 0.85.<sup>55</sup> Of course the bidder can increase her chance of winning the property by bidding more than 96.25, but the increase in probability of victory is more than offset by the reduced margin

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<sup>53</sup>Assume, as I do in the Appendix, that the auction is conducted in increments of 1 and that it begins with a bid of 81 from the bidder. The rightholder must bid 82 to stay in the contest. The slim chance that  $V_{RH}$  is less than 82 is multiplied by the bidder's gain of 19 to determine the bidder's expected gain at this bid. This process is repeated for bidder bids of 83, 85, etc., up to the bidder's final possible bid at 99. If the rightholder bids 100, of course, the bidder withdraws from the auction. The sum of the products of gain and probability at each step in the auction produces the overall expected gain to the bidder of 2.0.

<sup>54</sup> $96.25 = 100$  (the mean of  $V_{RH}$ ) -  $.75 \times 5$  (the standard deviation of  $V_{RH}$ ).

<sup>55</sup>More generally, the expected return utilizing the optimum bid in the right of first refusal scenario when  $V_{RH}$  is normally distributed about a mean equal to  $V_B$  is 0.17 times the standard deviation of  $V_{RH}$ .

between her bid and her value. Similarly, the larger prize achievable by bidding less than 96.25 is more than offset by the reduced probability of winning.<sup>56</sup>

Note that the bidder's ability to optimize her bid in the right of first refusal case is dependent on accurate estimation of both the mean and standard deviation of the distribution of the rightholder's value. Error in either direction on either measure will cause the bidder to choose a suboptimum bid, further reducing her expected gain. By comparison, estimation errors in the auction scenario have no effect on the actual bidding process. Thus, the calculated reduction in the bidder's expected return, from 2.0 to 0.85 in my example, is really the best a bidder could hope for in a right of first refusal situation. In reality, given the inability to perfectly optimize a right of first refusal bid, the reduction in expected gain will be larger.<sup>57</sup>

#### **D. Conclusions and Implications for the Parties**

*1. Impact on the Bidder.* Facing significant search and negotiation costs, a third party is discouraged from bidding against a right of first refusal by the reduction in the expected payoff caused by the instrument. The degree to which a third party is dissuaded should depend on the variability of the rightholder's value. This impact is not effectively ameliorated by the possibility of subsequent transfer.

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<sup>56</sup>As this discussion indicates, and as the Appendix demonstrates, the optimum bid can be determined by trial and error using probability tables.

<sup>57</sup>The results of the auction and right of first refusal analyses are directionally the same, although the expected gains differ, if  $V_B$  is greater or less than the mean of  $V_{RH}$ .

*a. Impact a function of the variability of the rightholder's value.* Compared with the auction scenario, the right of first refusal format places the outside buyer at a serious informational disadvantage. A simpler and perhaps more intuitive way to see the impact is to recall that in an auction the bidder will succeed at  $V_{RH}$  each time  $V_B$  is greater than  $V_{RH}$ . In the right of first refusal situation, the bidder will succeed at  $V_{RH}$  or higher, since the bidder lacks the information produced by the auction, and the bidder will sometimes fail even when  $V_B$  is greater than  $V_{RH}$ . The reduction in expected gain for the third party created by the right of first refusal deters the outsider from investing in search and negotiating costs. Further, the larger the standard deviation of  $V_{RH}$ , the greater the impact of the right of first refusal. In my example, the right of first refusal costs the bidder at least 0.23 times the standard deviation of the rightholder's probabilistic value.<sup>58</sup> It follows then that a right of first refusal will have a larger deterrent effect on buyers when an insider's valuation is subject to wide variation. Variation in an insider's valuation is likely to be significant in cases involving close corporation shares or other unique property because of the inherent difficulty of valuing such property accurately and the potential for high insider idiosyncratic value.<sup>59</sup> Relatively high transaction costs faced by buyers, of course, become even more daunting as the expected return is depressed by the presence of the right of first refusal.<sup>60</sup>

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<sup>58</sup>An expected gain of 0.4 standard deviations in the auction case minus an expected gain of 0.17 standard deviations given an optimum bid in the right of first refusal case. *See supra* notes 53-55 and accompanying text.

<sup>59</sup>*See supra* Part II.B.

<sup>60</sup>A third party in close competition with a rightholder may be less dissuaded from bidding than this analysis suggests because that bidder would benefit from the rightholder paying more to the seller for the seller's property. In such a case the third party has an additional incentive to bargain aggressively despite the reduction in expected gain created by the right of

*b. Impact not significantly ameliorated by the possibility of subsequent transfer.* Part of the right of first refusal's cost to the bidder results from the misallocation of the property to the rightholder in situations in which the bidder has a higher value. This cost can be ameliorated if the rightholder can resell the property to the bidder. There are a number of obstacles to improving the parties' position through subsequent transfer, however. First, in losing the contest the bidder does not learn whether her value is above or below the value of the rightholder; she only knows that her *bid* was less than that value. So, further negotiation may be futile and may not be initiated by the unsuccessful bidder. If the bidder does choose to negotiate with the rightholder and learns through negotiation that her value is indeed greater than  $V_{RH}$ , and assuming some equality of negotiating skill, the bidder will succeed only at a price between  $V_{RH}$  and  $V_B$ , a price above that which would have succeeded at auction. Second, in some situations further negotiation between the successful rightholder and the still interested bidder cannot be undertaken without retriggering the right of first refusal process. For example, if one shareholder of a close corporation has exercised the right to preempt, the other shareholders would still have a right of first refusal on the proposed resale of those shares to the bidder. Third, in more unusual situations involving rights to lease or sell, the subject of the right of first refusal may not be transferable or the opportunity to reallocate may expire quickly.<sup>61</sup> For these reasons and

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first refusal. If the third party succeeds, he acquires the property; if he fails, then at least the costs of his competitor are increased. Professional sports teams negotiating with players whose contracts grant their current teams a right of first refusal provide an example of this effect. In addition to seeking the best players, each team should also benefit from driving other teams toward league salary caps. Of course, in the closed world of the professional sports league, a team adopting this strategy can expect reciprocation, and the participants may decide that collusion to keep salaries down is a better overall strategy.

<sup>61</sup>Suppose, for example, that  $X$  has a right of first refusal to *sell* a load of pipe to  $A$  for delivery by a certain date.  $X$  matches a price negotiated between  $Y$  and  $A$  for the sale of that pipe.

others, the possibility of subsequent transfer may reduce, but will not eliminate, the misallocation problem.

Moreover, misallocation of the property reflects just one component of the reduction in expected gain faced by a third party who bids for property encumbered by a right of first refusal. The bidder's expected gain is also reduced by successful bids that exceed  $V_{RH}$ . The subsequent transfer possibility does nothing to alleviate this cost to the bidder.

*c. Anecdotal evidence as to the impact on outside bidders.* Anecdotal evidence from practitioners confirms the inhibiting effect of rights of first refusal on third-party bidders. One lawyer with extensive experience with close corporations suggested that a right of first refusal essentially makes shares of a unique firm unmarketable.<sup>62</sup> A real estate attorney confirmed that buyers do not want to get involved in bidding on property encumbered by rights of first refusal.<sup>63</sup> Further evidence of the magnitude of the encumbrance is offered by agreements providing for the reimbursement of transaction costs incurred by unsuccessful bidders. In a set of agreements that granted one class of security holders a right of first refusal on the resale of another class of securities, the corporation was committed to reimburse legal and due diligence expenses of an unsuccessful outside bidder up to \$500,000.<sup>64</sup>

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*X* now has a binding agreement to deliver pipe to *A*. Although *Y* may be able to fabricate the pipe for less and share the gain with *X*, *X* may have no right to substitute another supplier in the contract. Moreover, even if *A* can be persuaded to amend the contract, the negotiating period, at the latest, expires on the delivery date.

<sup>62</sup>Telephone interview with Jeanne Rickert; Jones, Day, Reavis & Pogue (Jan. 1998).

<sup>63</sup>Telephone interview with George R. Barry; Squire, Sanders & Dempsey, L.L.P. (Jan. 1998).

<sup>64</sup>Option Agreement § 5.04 (April 10, 1992) (private agreement, on file with author).

**2. Impact on the Seller and the Rightholder.** The contracting parties lose nothing by adopting a right of first refusal that discourages a single outside bidder. Once we expand the model to allow for the possibility of several competing outside bidders, however, the cost to the seller and rightholder of dissuading such bidders becomes apparent.

**a. A single outside bidder.** Ideally, the parties to the right of first refusal contract, the owner and the rightholder, evaluate the impact of the encumbrance at the time of contract formation. Assuming that they can properly evaluate the costs that will arise when and if the owner decides to sell and that they can allocate these costs between themselves at the outset, the parties' principle concern is the combined net cost to them when and if a sale is made. If the parties could be guaranteed that there would be a single outside bidder at the time of sale, whether they create the right of first refusal or not, they would not be dissuaded from creating the right of first refusal. We saw above that, given a single bidder, the seller and the rightholder in combination are better off under the right of first refusal. They are happy that the outsider is bidding blindly against a right of first refusal since, in an auction between the rightholder and a single bidder, the seller cannot extract any value from the outside bidder beyond the value of the rightholder.<sup>65</sup>

**b. Multiple outside bidders.** If, however, there are several potential outside bidders with values above  $V_{RH}$ , a progressive auction would allow the seller to capture value above  $V_{RH}$ . Assume that  $V_{RH}$  is 96 and that a single outside bidder, Bidder 1, has a value of 100. As we have

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<sup>65</sup>Theoretically, a portion of the bidder's surplus value could be captured if the seller transferred the property to the rightholder and allowed the rightholder to negotiate directly with the bidder. The difficulty would lie, however, in valuing the transfer from the seller to the rightholder and in dividing the surplus captured from the bidder. A central priority in selecting an instrument must be to determine objectively the price due to the seller on transfer.

seen, at auction Bidder 1 wins at 96 and the contracting parties jointly gain nothing above  $V_{RH}$ . Now assume that a second outside bidder, Bidder 2, has a value of 102 and that a third outsider, Bidder 3, has a value of 104. In a progressive auction between these four candidates, Bidder 3 will succeed at the next highest valuation 102. Of course, the seller can never extract the winner's surplus in an auction; that increment between the highest and next highest valuation is kept by the winner. It is clear, however, that if the presence of a right of first refusal discourages the entrance of bidders, as it should given the reduction in a bidder's expected return, then the parties to a right of first refusal contract reduce the potential realization from disposition of the property by adopting the instrument.<sup>66</sup>

If the encumbered property is a share of Microsoft, then, even if a few bidders are discouraged by a right of first refusal, a very slight reduction in offering price would provide plenty of outside interest, and the contracting parties would lose very little by the encumbrance. In such a case, however, the contracting parties had little to gain from encumbering the property with a right of first refusal. Nonetheless, this example highlights two general points. First, the cost to the contracting parties due to the reduction in outside interest should roughly correlate to the disadvantage faced by a third-party bidder. Second, the outsider's disadvantage is greatest with unique property subject to high search and negotiation costs and a wide variance in potential value to the rightholder.

The seller may offset the impact of the right of first refusal and encourage outside bidders to enter the fray by contracting with bidders to reimburse their transaction costs. This solution

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<sup>66</sup>Recall that I am assuming that transfers between the contracting parties can be settled ex ante, so the parties have a mutual interest in extracting as much value as possible from third-party bidders. See *infra* notes 120-21 and accompanying text for more on this point.

may not improve the contracting parties overall position, however. As shown, the seller needs several bidders to extract value above  $V_{RH}$ , and the seller may be required to reimburse costs for several parties. Moreover, the seller has no way of knowing that the bidders who are induced to join the contest will have a valuation higher than that of the rightholder, so often the reimbursement will be wasted.<sup>67</sup>

Ex post, the right of first refusal obstacle will be costly for the seller when the property is worth more to several outsiders than it is to the rightholder, when a portion of the outsiders' surplus value could be captured by auction or otherwise, and when the impact of the right of first refusal is sufficient to deter most or all of these outsiders from bidding. I have discussed the factors that influence bidder reaction to the right of first refusal in a relative sense, but it is impossible to say anything concretely about the frequency or magnitude of this cost. Nonetheless, the fact that some parties are willing to provide sizable inducements to encourage the participation of third-party bidders indicates that the impact can be significant.<sup>68</sup>

### **III. FIRST PROPOSED JUSTIFICATION FOR RIGHTS OF FIRST REFUSAL -- INSURANCE AGAINST BARGAINING BREAKDOWN**

This Part asks why contracting parties would adopt a right of first refusal and forego upside realization potential on the sale of property. The hypothesized answer is that the right of first refusal provides insurance against bargaining breakdown between the contracting parties. In

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<sup>67</sup>I have assumed throughout that the owner's reservation price is low enough that it can be ignored safely. If the owner is considering an opportunistic sale, however, the presence of the right of first refusal may depress the realizable price of the property so much that it dissuades the owner from selling. The loss in utility if the owner is locked-in by the right of first refusal could be considered another cost of the instrument.

<sup>68</sup>*See supra* note 64 and accompanying text.

essence the argument runs as follows: The contracting parties do sacrifice some upside potential if outsiders who value the property highly at the time of sale are driven away, but ex ante the parties are more concerned about the possibility that the rightholder will have the highest value at sale time, and that something could go wrong in a negotiation between the seller and the rightholder that would jeopardize the high insider value.

Section A explains that the traditional justifications for rights of first refusal, particularly in the close corporation context, are really arguments about insurance against bargaining breakdown. Section B examines bargaining between insiders in the absence of rights of first refusal. Recognizing that an insider may place a high idiosyncratic value on the property, a rational seller, I argue, would not conduct an auction but would negotiate directly with the insider in an attempt to extract a portion of that idiosyncratic value. Given the negotiating framework selected by the seller, Section C analyzes the factors that could lead to a breakdown in bargaining and suggests that co-venturer and other relationships in which rights of first refusal are typically found are susceptible to bargaining failure. Section D looks at the cost of a breakdown if it occurs and finds that because of the likelihood of insider idiosyncratic value that cost is likely to be high.

#### **A. Traditional Justifications are Really Bargaining Breakdown Justifications**

The literature on close corporations provides several justifications for the restrictions placed on share transfer. Easterbrook and Fischel note that it is appropriate to restrict alienation in the close corporation context because the investors manage such ventures and the restrictions improve the odds of maintaining compatible management.<sup>69</sup> Moreover, they note that the

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<sup>69</sup>See EASTERBROOK & FISCHEL, *supra* note 3, at 228-29.

restrictions may ensure that control remains within a family, which may limit opportunistic conduct.<sup>70</sup> O’Neal and Thompson echo these sentiments and explain that when shareholders manage they rationally want to retain the power to choose their future associates and to prevent the entry of outsiders of dubious integrity or business judgment.<sup>71</sup> O’Neal and Thompson provide a number of regulatory and tax advantages to controlling the number and identity of shareholders, as well.<sup>72</sup>

These rationales, however, only explain why the insiders of a close corporation may place a higher value on the shares being sold than would an outsider. Assuming that the insiders are equally free to purchase from the departing shareholder, these observations do not in themselves justify the transfer restrictions. If the insiders value the shares highly, normally we would expect that they would buy them.

Similarly, in the real estate context, I noted in Part II that a franchisee or lessee may value continuation in the premises highly due to the costs and potential loss of goodwill that would follow from relocation. Given the opportunity to buy the property outright and ensure such continuation, the tenant may be eager to purchase. However, this reasoning only explains why the tenant would be an aggressive bidder; it does not explain why a right of first refusal is necessary.

Clearly the unspoken assumption behind each of these justifications is that, in the absence of the restriction, something may go wrong in the negotiation between the seller and the highly

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<sup>70</sup>*See id.* at 229.

<sup>71</sup>*See* O’NEAL & THOMPSON, *supra* note 3, § 7.02.

<sup>72</sup>*See id.*; *see also* Norton, *supra* note 4, at 804 (summarizing purposes of stock transfer restrictions).

valuing insider. Bargaining then may breakdown, and the property may be sold to a lesser-valuing third party. I do not mean to imply that the writers providing these justifications were unaware of this necessary additional step in the argument. On the contrary, it was obvious. I merely wish to make it explicit.<sup>73</sup>

Other cases and commentators suggest that by decreasing uncertainty the right of first refusal facilitates investment by rightholders.<sup>74</sup> A lessee, for example, faces a number of investment opportunities with regard to the leased property, many of which will not be transferable to a new location. In evaluating these options, the lessee faces one risk that the property owner will not renew the lease at the end of its term. A second risk is that the property will be sold and that a new owner will refuse to renew. The right of first refusal at least guarantees the lessee the opportunity to avoid the second risk, which may facilitate his earlier investments in the property. The risk avoided by the right of first refusal is the risk that the lessee will fail to consummate a purchase of the property even if he has a higher value, in other words, that bargaining will breakdown. Thus, traditional justifications, whether they focus upon reasons insiders value property highly or upon investment facilitation, are fundamentally about

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<sup>73</sup>Professor Kahan does make this point explicitly. *See* Kahan, *supra* note 3.

<sup>74</sup>*See, e.g.,* American Broadcasting Cos. v. Wolf, 430 N.Y.S.2d 275, 280-81 (N.Y. App. Div.), *appeal dismissed*, 413 N.E.2d 1173 (N.Y. 1980), *aff'd*, 420 N.E.2d 363 (N.Y. 1981) (“[T]he right of first refusal is used throughout the radio and television industry as a device in aid of the broadcaster-employer’s retention of the services of major talent in whom the broadcaster has made a significant investment.”); Christopher T. Wonnell, *The Contractual Disempowerment of Employees*, 46 STAN. L. REV. 87, 108 (noting that in *Wolf* the employee agreed to the first refusal provision to assure the employer that its investment would not be lost to a competitor). *See also* Kahan, *supra* note 3 (describing the investment facilitation phenomena and suggesting a hypothetical similar to that which follows).

the risk that the higher valuing insider will fail to consummate a purchase, despite his higher valuation. It is this risk that creates the incentive for the restriction.

### **B. Bargaining Between Insiders in the Absence of a Right of First Refusal**

In Part II, I compared the bargaining dynamics and economics pertaining to the sale of property encumbered and unencumbered by a right of first refusal. In the case of unencumbered property I assumed that the seller would conduct a progressive auction. In an auction the insider -- the co-venturer, lessee, or other party that would have held the right of first refusal if it existed -- would be assured of acquiring the property if it valued the property more highly than any third party, and, thus, the insider would face no risk of losing his idiosyncratic value or of wasted investment. However, the seller in the auction scenario receives only the second-highest value and is unable to capture any of the idiosyncratic value placed on the property by the insider. If the seller believes that his co-venturer or lessee places a high idiosyncratic value on the property, the seller has a strong incentive to avoid an auction and negotiate directly with that insider in hopes of capturing some of the insider's premium value. This negotiating stance creates the potential for bargaining failure.

Suppose, for example, that one of two shareholders of a close corporation contemplates selling out and retiring. (I'll call the other shareholder the seller's "partner" ignoring the corporate formality.) The seller has spoken with her partner and knows that he wishes to buy her shares and bring his sons into the business. The seller also knows that her partner would be very unhappy to have an outsider thrust upon him at this stage of the business. The seller does not object to selling to her partner, but she has her sights set on a plush retirement and wants to maximize her realization. Both parties realize that the book value of the company stock is meaningless as the firm's value largely rests in the potential of several promising new products.

The partner decides that his reservation price is 150.<sup>75</sup> There are no rights of first refusal on the sale of these shares.

The seller enlists an investment banker who indicates that an outside buyer probably could be induced to pay up to 100. The banker indicates that the true value is certainly higher, but that any outsider is going to discount the asset values and expected cash flows of the corporation because of the 50/50 control split with the partner and the uncertainty that the division of control entails. The value of 100 achievable in a sale to an outsider sets the seller's reservation price.

Because an auction between the partner and an outside bidder is unlikely to generate more than 100 for the seller, the seller's best strategy, it would seem, would be to skip the auction and negotiate directly with her partner based upon the threat of selling to an outsider. In such a negotiation neither party knows the other's reservation price. Although it is true that the partner can enlist his own banker to value the business, the partner would realize that there is a great deal of uncertainty in the valuation process. The seller, on the other hand, may suspect that her partner places a large premium on the shares, but she can't determine how high a price he will pay. Assuming roughly equal negotiating skill, one would expect the parties to agree to a figure somewhere in the middle; perhaps they would settle at 125.

If the negotiation between the partners unfolds as described, the introduction of a right of first refusal only serves to transfer wealth from the selling to the remaining shareholder. Suppose that with the encumbrance of a right of first refusal the seller only can find one interested bidder,

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<sup>75</sup>Throughout this discussion the term "reservation price" simply refers to a party's indifference point -- the maximum price that would be acceptable to a buyer or the minimum price acceptable to a seller in a negotiation.

who offers 90. In such a case the right of first refusal transfers 35 from the seller to her partner. The transfer alone obviously fails to justify the right of first refusal since at the time of contract formation neither party knew which partner would sell first and which would remain. More importantly, as shown above, by incorporating the right of first refusal the parties risk dissuading bidders who may place a value on the property above that of the remaining shareholder. A successful negotiation between the parties is just one possible outcome, however, bargaining breakdown is another.

### **C. Factors Contributing to Bargaining Breakdown in the Absence of a Right of First Refusal**

Generally we expect multiple-round bargaining to succeed when a zone of agreement exists, that is, when the buyer's reservation price is greater than the seller's, as will often be the case in the arrangements that generate rights of first refusal. A number of factors, however, can contribute to a breakdown in bargaining despite the existence of a zone of agreement, and the relationships in which rights of first refusal are found appear to be quite susceptible to bargaining failure.<sup>76</sup>

*1. Strategic Bargaining and Power Inequality.* Strategies adopted by a bargainer to maximize his share of the joint value achievable through the negotiation put the successful consummation of the negotiation at risk. Such strategies, however, are universally employed and

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<sup>76</sup>The discussion that follows focuses on issues that appear to be particularly relevant to bargaining between insiders in the absence of rights of first refusal. Obviously many other factors affect bargaining success or failure. *See generally* BARRIERS TO CONFLICT RESOLUTION (Kenneth J. Arrow et al. eds., 1995); JEFFREY Z. RUBIN & BERT R. BROWN, THE SOCIAL PSYCHOLOGY OF BARGAINING AND NEGOTIATION (1975).

Although the examples that follow concentrate on bargaining between co-venturers, the observations are equally applicable to other right of first refusal situations.

range from simple deception as to a party's true level of interest to credible threats to terminate negotiations and walk away.<sup>77</sup> It has been suggested, however, that more successful bargaining tends to result when the bargaining power of the parties to the process is evenly balanced, as, for example, when both parties possess an ability to lodge credible threats.<sup>78</sup>

Because the joint value of the bargain is effectively set by the difference between an insider's and an outsider's value, the insiders bargaining in the absence of rights of first refusal are primarily negotiating over the division of the pie.<sup>79</sup> Thus, the focus of the parties tends to be concentrated not on joint value maximization, but on strategies for appropriating the maximum share, a focus that may threaten the success of the negotiation. Moreover, bargaining power often is unequally distributed among insiders bargaining in the absence of a right of first refusal. A partner who is cashing out, as in the example above, may be in a hurry to receive her cash while the remaining partners may approach the negotiations in a more leisurely fashion. Such one-sided time pressure reduces the seller's bargaining power. Moreover, unlike the inside buyer, the seller may have no credible threat of breaking off negotiations if pushed down towards her reservation price. As a one-time player, the seller gains nothing from terminating the

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<sup>77</sup>See Robert H. Mnookin & Lee Ross, *Introduction*, in BARRIERS TO CONFLICT RESOLUTION, *supra* note 76, at 3, 7-10.

<sup>78</sup>See RUBIN & BROWN, *supra* note 76, at 199.

<sup>79</sup>In many negotiations the size of the pie, as well as its division, is at issue. A labor negotiation, for example, may produce an agreement that increases productivity and enterprise profits that may be shared in the future. In such a case the parties should focus, at least in part, on pie maximization. By contrast, rights of first refusal almost always arise in situations in which a relationship is being terminated. For example, a close corporation shareholder may be departing or a lessee may be buying out his lessor. In these situations there will be no ongoing relationship through which to share subsequent gains and, thus, no incentive to jointly maximize the pie.

negotiation and selling to a lesser valuing outsider. On the other hand, the seller may have equal or greater power if the seller is a repeat player who has a credible incentive to break off negotiations to create or maintain a reputation as an effective bargainer<sup>80</sup> or if the remaining partners are very concerned about a sale to an outsider. In any event, disparities of power and the use of strategic bargaining would seem to be common in negotiations between insiders in the absence of a right of first refusal.

**2. Equity Barriers.** Because a small gain is better than no gain, I suggested above that a powerless, one-time seller being driven down towards her reservation price is not likely to break off negotiations or to pose a credible threat to do so. Although this would appear to be the position of a perfectly rational seller, in the real world bargainers may refuse to accept outcomes that deviate too far from what they perceive to be a fair result and may, in fact, accept an economic loss to avoid providing an undeserved windfall to the other party to the negotiation. This equity barrier to consummation has been demonstrated experimentally through games in which two parties with an equal basis for claiming a gain undergo take-it-or-leave-it bargaining. In this “ultimatum game” one party proposes a division of the gain which the other party may accept or reject. If the division is accepted, each party keeps his share; if rejected, the parties

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<sup>80</sup>A close corporation shareholder who is selling off only a portion of her interest may have an incentive to break off negotiations and sell to an outsider at a price below that offered by an overly aggressive insider. The loss incurred by the seller in the first round may be recouped when she goes to sell a second tranch of shares if her partners then negotiate more circumspectly. It is unlikely, however, that a close corporation shareholder would be in such a position. Agreements often limit shareholders to making a complete divestiture on retirement or death. Even if piecemeal sale is permitted, a partially divested shareholder may find herself in a difficult minority position. By contrast, commercial real estate participants are more likely to be repeat players by virtue of their involvement in numerous deals. Within a given venture, however, their interests may not be divisible.

receive nothing. Ultimatum offers of significantly less than fifty percent are frequently rejected.<sup>81</sup>

Equity barriers may be important in the negotiations with which I am concerned for two reasons. First, given the frequent inequality in bargaining power, the high-power party may be tempted to insist on a severely disproportionate division of the joint value which the low-power party may reject on fairness grounds.<sup>82</sup> Second, it will be more difficult to decide what is fair and, thus, to arrive at a fair division in many of these longstanding relationships. To whom should the value associated with maintaining family control be assigned? How much should the departing partner get for his years of hard work? What was the original understanding when the business was formed many years ago?<sup>83</sup>

**3. *Poor Relationships and Illicit Utility in Disagreement.*** In discussing equity barriers, I assumed that a zone of agreement existed but that agreement failed due to one party's overreaching, which led to rejection by the other. Serious biases, however, could eliminate the zone of agreement. One partner may be leaving a venture specifically because of a soured

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<sup>81</sup>See Mnookin & Ross, *supra* note 77, at 10-13, for a general discussion of equity barriers to conflict resolution. A classic experimental study of the ultimatum game is reported in Werner Guth, Rolf Schmittberger, & Bernd Schwarze, *An Experimental Analysis of Ultimatum Bargaining*, 3 J. ECON. BEHAV. & ORGANIZATION 367 (1982). More ultimatum game studies and analyses are presented in Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

<sup>82</sup>More typically, the high-power party will anticipate the fairness behavior of the low-power party and will temper his demands accordingly. See Jolls et al., *supra* note 81. Thus, equity barriers alone do not routinely lead to bargaining breakdown. Because some high-power parties will fail to account for the fairness response, however, this phenomenon does contribute to a certain amount of bargaining failure.

<sup>83</sup>One might expect that experienced bargainers would be less susceptible to this bias and more likely to act in accordance with rational expectations. This suspicion is not backed up by the experimental evidence, however. See Jolls et al., *supra* note 81.

relationship. Bargaining over the value of the departing partner's interest against a backdrop of acrimony increases the difficulty of a task that is not easy under the best of conditions. Moreover, an extremely disgruntled partner may receive utility from the prospect of forcing an outsider upon the remaining partners. If the remaining partner values the property at 110, a disgruntled seller who receives value of 10 from disrupting the venture will be willing to sell to an outsider at 100. The failure of the seller and the partner to reach agreement in this latter case is not, strictly speaking, an example of bargaining breakdown. There was no bargain to be reached. Nonetheless, the parties may prefer to guard against the introduction of such illicit utility into the bargaining situation. Although any relationship may be susceptible to such souring, close corporation or other co-venturer relationships, which often involve family as well as business ties, probably are more likely to suffer from this defect than are leasing and franchising relationships.<sup>84</sup>

**4. *The Seller's Utility in Selling Outside of the Venture.*** Even absent hostility between the parties, situations may arise in which an owner receives utility from selling outside of the venture. In some ventures, such as jointly owned oil pipelines, partners are also competitors. All else being equal, a departing partner may prefer that its interest be transferred to a third party in order to avoid enlarging the market share of any of the remaining partners/competitors. As in the case of the particularly disgruntled shareholder, a failure to reach agreement between the departing and remaining partners may then follow from the lack of a potential bargain, rather

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<sup>84</sup>One suspects that inexperienced bargainers may be less able to put aside hard feelings and complete a negotiation in a poisoned environment. If so, shareholders of close corporations, who often have little experience in negotiating matters as significant as the departure of a partner and the future of the business, may face an added obstacle to consummation.

than from bargaining breakdown. Again, however, the partners may prefer to protect against such an eventuality.

**5. *Asymmetric Information.*** Information disparities are a serious problem in single-round bargaining. Essentially it is an information disparity that places the outside bidder in such an awkward position in the single-round right of first refusal scenario. In multiple-round negotiations information asymmetries are less of a barrier to completion as information is gained through the bargaining process. Nonetheless, if the seller in my earlier example cannot convince her partner that her reservation price is not below 100, the partner may push too far and the shares may be sold elsewhere.

Although one would normally expect co-venturers and others involved in ongoing relationships to possess roughly equivalent information concerning the business,<sup>85</sup> the parties in the negotiations with which I am concerned face a critical information gap. I have argued that in the absence of a right of first refusal a departing partner often will choose a negotiation over an auction in order to capture a portion of the remaining partner's idiosyncratic value. The departing partner can only guess at the *extent* of this idiosyncratic value, however. Only the remaining partner knows what retention of family control, for example, is really worth to him.

In combination the foregoing factors suggest that the failure of parties to reach agreement, where on the surface an agreement appears achievable, will not be uncommon. As noted, utility derived from selling to an outsider reflects a situation in which the surface appearance of a zone of agreement is illusory. Because the parties may choose to protect against these "unusual" utility barriers, as well as against the traditional barriers of strategic bargaining,

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<sup>85</sup>At the least we would expect parity of information to be greater between co-venturers than between strangers.

equity concerns, poor relationships, and information asymmetry, we may consider them all as factors contributing to bargaining breakdown.

#### **D. The Cost of Bargaining Breakdown and the Decision to Buy Insurance**

In determining whether to invest in a right of first refusal as insurance against bargaining breakdown, the contracting parties must consider the cost of that eventuality as well as its likelihood. If a zone of agreement does exist between the departing and the remaining partners, the immediate cost of a breakdown in bargaining is simply the difference between the value placed on the property by the remaining partner and the sale price to the outsider.<sup>86</sup>

The likelihood that an insider will place idiosyncratic value on the property at the time of sale is central to the question of whether the parties will wish to purchase insurance against bargaining breakdown.<sup>87</sup> Compare the shareholder of the publicly traded company with the close corporation shareholder I have focused upon above. Because management and ownership are not tied in the public company and the voting power associated with any small tranch of shares is negligible, the public company shareholder is indifferent to the identity of her investment partners in the venture. Thus, unless the accumulation of a control block is at issue, public company shareholders place no idiosyncratic value on the shares owned by others. Such shareholders have no interest in maintaining the status quo or in blocking certain buyers, would

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<sup>86</sup>If in my previous example the departing partner, after a breakdown in bargaining, sold her shares for 100 to an outsider while the remaining partner valued the shares at 150, the cost of bargaining breakdown is 50. I view this as a joint cost to the contracting parties, the two partners, who in this case did not create any insurance against bargaining breakdown.

<sup>87</sup>The potential for significant insider idiosyncratic value may correlate with the uniqueness of the property. *See supra* notes 42-43 and accompanying text.

suffer no cost due to bargaining breakdown, and obviously would be unwilling to purchase insurance against that eventuality.

Risk aversion also may factor into the willingness of the participants to purchase insurance against bargaining breakdown. The likelihood of bargaining breakdown between the departing and remaining participants of a close corporation may be quite small, but the costs of breakdown may be very high.<sup>88</sup> Often, both the shareholder's wealth and employment are tied up in the close corporation.<sup>89</sup> This high exposure suggests that a right of first refusal may be incorporated as insurance even if the expected cost exceeds the expected benefits. A lessee or franchisee whose livelihood is tied to the business also may be significantly risk averse. By contrast, a commercial investor involved in a number of projects is likely to be less risk averse and is less likely to purchase expensive right of first refusal insurance for any given venture.

Finally, as discussed in Part III.A, the existence of a right of first refusal facilitates investment in the venture and adds value even if the right is never exercised.<sup>90</sup> One cost of failing to insure against bargaining breakdown, then, may be a reduction in profitable investment in the enterprise. The influence of this factor will vary case by case. For example, a lessee generally has no assurance of renewal at the end of the lease term. The insertion of a right of first refusal, which protects only against the substitution of an unfavorable lessor, should have a modest impact on the lessee's appetite for investment. The shareholders of the close corporation,

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<sup>88</sup>*See supra* notes 69-72 and accompanying text.

<sup>89</sup>*See* EASTERBROOK & FISCHER, *supra* note 3, at 229 (“investors in closely held corporations have large percentages of their wealth tied up in one firm”); O’NEAL & THOMPSON, *supra* note 3, §1.08 (“employment by the [close] corporation is often the shareholder’s principal or sole source of income”).

<sup>90</sup>*See supra* note 74 and accompanying text.

on the other hand, may be significantly influenced in their investment decisions by the security that is provided by a right of first refusal.

#### **IV. ALTERNATIVE MEANS OF INSURING AGAINST BARGAINING BREAKDOWN**

I have hypothesized that rights of first refusal are desirable to the contracting parties because they provide insurance against bargaining breakdown. The previous Part demonstrated that such insurance is valuable in the circumstances in which rights of first refusal are used, because the threat of bargaining breakdown absent such protection is quite real and significant insider idiosyncratic value may be at risk. As we have seen, however, a right of first refusal imposes a cost on the contracting parties by discouraging third parties from bidding. It is not possible to say generally whether the insurance benefit exceeds the cost, but the discovery of a more efficient alternative to the right of first refusal -- an instrument that provides equivalent insurance at a lower cost -- would undermine the insurance justification for the right of first refusal. This Part examines alternative means of insuring against bargaining breakdown and concludes that the right of first refusal can be improved upon.

Section A investigates several traditional alternatives to the right of first refusal -- contractual provisions that are employed or have been employed in similar circumstances -- but the analysis suggests that none of these devices provides an adequate substitute for the right of first refusal. Section B, however, argues that equivalent insurance against bargaining breakdown could be provided at a lower cost through the adoption of a new device, a commitment to auction.

## A. Traditional Alternatives to the Right of First Refusal

1. *The Appraisal, Market Index, and Fixed Price Alternatives.* The ideal instrument for the contracting parties would guarantee the rightholder an opportunity to purchase the asset at the best price available to the seller from an uninhibited group of third-party buyers. The right of first refusal, as we have seen, inhibits buyers. It drives some away and causes the still willing bidder to strategically bid below his value. If a market price for the property could be determined objectively, uninfluenced by the existence of the right of first refusal, and used as the rightholder's triggering price, the contracting parties would be better off.<sup>91</sup> The difficulty is that only the most fungible or commoditized property is susceptible to accurate, objective pricing by way of appraisal or market index, and, as we have seen, property that is fungible or commoditized is less likely to carry idiosyncratic value and warrant protection against bargaining breakdown.<sup>92</sup> Bushels of wheat and shares of Microsoft are readily appraisable, but there is no incentive to subject these assets to a right of first refusal. In addition to being subject to rights of first refusal, close corporation shareholders often have the right to sell their shares back to the

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<sup>91</sup>The contracting parties would be better off because of the reduced possibility that a sales opportunity to a third party at a price above the rightholder's value has been missed.

<sup>92</sup>This is the one point in the analysis in which the correlation, or lack thereof, between uniqueness and insider idiosyncratic value does make a difference. If fungible property carries significant idiosyncratic value, the appraisal strategy could be superior to the right of first refusal. Many commercial real estate properties, particularly facilities which are leased or franchised in large numbers, such as gas stations, should be appraisable with reasonable accuracy. Moreover, strong goodwill could create idiosyncratic value for the lessee or franchisee. But as suggested *supra* note 43, one would not expect a franchisee to rely on a right of first refusal to protect that idiosyncratic value.

corporation at an appraised price. Given the lack of a liquid market for these shares, however, such appraisals are not expected to be highly accurate.<sup>93</sup>

Perhaps the accurate appraisal problem associated with relatively unique property has contributed to some of the rare fixed price rights of first refusal that have been granted. As we noted in Part I, however, fixed price triggers are unlikely to mirror reality, particularly over extended time periods.

Some assets may be susceptible to objective pricing in the future by way of a market index. Parties dealing with renewals or renegotiations that are certain to occur may find it worthwhile to invest in the formulation of an index in order to preempt future bargaining difficulties with respect to these assets. The right of first refusal serves to protect against a contingency that may never occur, however. Thus, the parties incentive to invest in a complex mechanism to replace such a right is much reduced.

**2. *Good Faith Commitment to Negotiate.*** As noted above, an exclusive commitment to negotiate for a fixed period places pressure on a time-sensitive party to reach agreement. Unless that pressure is significant, however, the commitment to negotiate does not eliminate the risk of bargaining breakdown. A commitment to bargain in good faith does not prevent an owner from attempting to extract a portion of the rightholder's idiosyncratic value. The parties could agree, *ex ante*, to negotiate towards a market price (as opposed to the best achievable price) if the

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<sup>93</sup>Agreements mandating that a close corporation buy out a shareholder, at least on retirement or death, are common. Given the cost and inaccuracy of market-based appraisal, however, less complex valuation methods, such as those employing modified book value, often are utilized. See O'NEAL & THOMPSON, *supra* note 3, § 7.26.

triggering event occurred, but such an agreement would be difficult to enforce unless the property were extremely fungible.<sup>94</sup>

**3. *Right of First Offer.*** Upon notice from the seller, the holder of a right of first offer is provided the opportunity to offer a price for the property which, if not acceptable to the seller, becomes the seller's floor in negotiating with other bidders.<sup>95</sup> In this situation the roles of the rightholder and the third-party buyer are reversed. Now the rightholder must calculate a single bid that maximizes his expected return in an information vacuum. As opposed to multiple-round negotiations between the seller and the rightholder, this approach apparently increases the risk of bargaining breakdown.

A variation on the right of first offer requires the *seller* to propose a price to the rightholder, which, if not accepted, becomes the seller's floor for negotiation with outside bidders.<sup>96</sup> Although the seller must propose the price, the rightholder again is in a disadvantaged

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<sup>94</sup>A commitment to negotiate may be entirely appropriate, of course, in many situations in which a right of first refusal is inappropriate. Consider, for example, how a true right of first refusal would play out in the employment context. An employee nearing the end of his contract would negotiate the best deal that he could with another employer. Then the current employer would have the right to preempt that deal and rehire the employee under the negotiated terms. Such an outcome would be fine if the employee were indifferent between working for one employer or another. If the initial employment relationship has soured, however, the employee faces the risk of becoming locked-in to an unsatisfactory arrangement. Even worse, the existence of the right of first refusal partially insulates the employer from the consequences of mistreating the employee. Most employees, one imagines, would be highly adverse to accepting such risk. Thus, true rights of first refusal in the employment context should be rarely observed. *See, e.g., American Broadcasting Cos. v. Wolf*, 430 N.Y.S.2d 275 (N.Y. App. Div.), *appeal dismissed*, 413 N.E.2d 1173 (N.Y. 1980), *aff'd*, 420 N.E.2d 363 (N.Y. 1981) (right of first refusal effectively served as a three-month non-compete clause and, although violated, was not specifically enforced).

<sup>95</sup>*See supra* note 15 and accompanying text.

<sup>96</sup>Condominium conversion statutes that grant first offer rights to apartment tenants frequently take this form. *See infra* Part VII.B.1.

position. The seller is not obligated to dispose of the property and may propose a relatively high price. The rightholder may have idiosyncratic value above this price but may pass, doubting that a third party will value the property so highly. Essentially, the rightholder is betting on receiving another opportunity to purchase at a lower price. In passing, however, the rightholder creates the possibility that a lesser valuing third party will purchase the property, exactly the eventuality that the right of first refusal was designed to avoid. Thus the right of first offer, however configured, is a poor substitute for the right of first refusal.

### **B. A Commitment to Auction as a Superior Insurer Against Bargaining Breakdown**

The threat of bargaining breakdown only arises when an opportunistic seller elects to negotiate one-on-one with an insider in an attempt to extract a share of the insider's idiosyncratic value. As with a right of first refusal, a commitment by the owner to dispose of the property by way of an auction in which the rightholder has an opportunity to participate provides complete insurance against bargaining breakdown. Unlike a right of first refusal, however, potentially high-valuing third-party bidders are not disadvantaged and driven away by an auction and, thus, the ex ante cost to the contracting parties of including such terms is reduced.

*1. The Design and Implementation of a Commitment to Auction.* Suppose that, in lieu of granting a right of first refusal, a lessor or co-venturer commits to publicly auction the property should he desire to sell. How would such a procedure work? First, let us dispense with the mental picture of a stockyard auctioneer. Although the model of the progressive, open-outcry auction is analytically useful, there are obvious drawbacks to requiring bidders for the shares of a

close corporation, for instance, to meet and participate in such an auction.<sup>97</sup> Luckily, however, the progressive-auction result can be duplicated by a sealed-bid procedure. It has been shown that awarding a property via sealed bid to the highest bidder, but at the second-highest price, induces each bidder to submit his full valuation and mirrors the result of the progressive, open-outcry auction.<sup>98</sup>

Thus, in implementation a commitment to auction would work very much like a right of first refusal. The rightholder would be notified of the owner's intention to sell and would be given requisite notice of the date on which sealed bids are due.<sup>99</sup> The owner would be permitted to set a reservation price, and the entire process could be managed by an escrow agent to ensure fairness. On the due date, the bids would be opened, and the property awarded to the highest bidder, or retained by the owner if no bid exceeded his reservation price.

**2. An Economic Comparison of the Commitment to Auction and the Right of First Refusal.** How are the parties affected by the switch from right of first refusal to commitment to auction? Essentially, this question was answered in Parts II and III. First, the protection offered

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<sup>97</sup>In addition to travel and coordination problems, participants in open-outcry auctions may be susceptible to psychological manipulation by other participants or the auctioneer. See, e.g., Doris Athineos, *How to Avoid Getting Hammered*, FORBES, Apr. 21, 1997, at 400-03.

<sup>98</sup>See William Vickery, *Counterspeculation, Auctions, and Competitive Sealed Tenders*, 16 J. FIN. 8, 20 (1961). In theory, the expected revenues from first-price-sealed-bid and from second-price-sealed-bid auctions are the same. A seller's choice between the two formats would depend on the risk of collusion and bidder risk aversion. See BRIAN HILLIER, *THE ECONOMICS OF ASYMMETRIC INFORMATION* 153-65 (1997).

<sup>99</sup>This procedure could be carried out in one step, as suggested above, or in two steps. In a two-step procedure the owner would notify the rightholder of the owner's intention to offer the property for sale and the rightholder would be required to trigger the sealed-bid-auction process. This two-step process would efficiently bypass the auction in cases in which, due to lack of funds or financing, for instance, the rightholder had no real interest in acquisition of the property.

against bargaining breakdown appears identical. I noted earlier that bargaining breakdown arises when the owner, expecting his partner or lessee to have a high idiosyncratic value, bypasses the auction and negotiates directly with the insider in order to extract a portion of that idiosyncratic value. If the owner commits to auction and the insider is given notice and an opportunity to participate, however, the possibility of bargaining breakdown is eliminated. As long as the insider places the highest value on the property, he will prevail at auction. So, in terms of insurance value, the right of first refusal and commitment to auction are equivalent.

Second, the ex ante cost to the parties of insuring against bargaining breakdown has been reduced by adoption of the commitment to auction. In Part II it was shown that a third-party bidder participating in an auction had a significantly higher expected gain than did a bidder bargaining in the face of a right of first refusal. By leveling the playing field for outsiders, the commitment to auction makes it easier for the seller to attract bidders and raises the probability of extracting value beyond that assigned to the property by the rightholder.

Of course the rightholder was getting a beneficial deal under the right of first refusal and, relative to that case, value is transferred from the rightholder to the seller under the commitment to auction. Thus far, however, I have ignored ex ante transfers between the contracting parties, confident that these can be worked out in contract formation. Subsequently, I will show that this factor actually favors the creation of commitments to auction.

**3. *The Practical Differences Between the Commitment to Auction and Right of First Refusal.*** Although the commitment to auction appears preferable theoretically, there are several practical differences between the instruments that may bear on the parties' selection. First, the seller conducting an auction must specify every element of the contract except for price. Under some right of first refusal agreements, the seller may have latitude to negotiate terms other than

price with interested bidders. This opportunity could result in an improvement in the contract for the seller and the third party. However, as noted in Part I, the parties to the right of first refusal agreement normally will limit the seller's ability to craft unique terms because such flexibility could be used to circumvent the right of first refusal. Moreover, nothing would bar a seller from optimizing auction terms through preliminary negotiations with interested third parties. Thus, this difference does not appear significant.

Second, the rightholder faced with an auction must conduct a detailed evaluation and precisely value the property prior to the submission of bids. Under a right of first refusal, a rightholder may have had a bid submitted to him that was clearly low or clearly high relative to his value and with respect to which little detailed analysis would be needed to accept or reject. If the particular arrangement is likely to generate frequent exercise opportunities, this drawback to the auction could be significant. For example, a close corporation arrangement could involve a sizable number of shareholders each of whom has the right to sell small tranches of shares. More typically, however, the opportunities for exercise will be infrequent, and the difference between the auction and right of first refusal scenarios will simply be in the timing rather than in the level of analysis undertaken by the rightholder. There is at least a partial offset to this effect as well. Under the commitment to auction, the third-party bidders need only assess their own valuation. The additional step of assessing the first-refusal rightholder's likely valuation and determining an optimum bid given that estimate is eliminated, and this effort does represent a small part of the transaction costs faced by outside bidders which directionally contributes to bidder flight and reduced value.

Overall, the additional analytical burden on the rightholder and increased specification requirements on the seller do not seem sufficient to outweigh the advantages the auction provides in retaining third-party bidders and preserving upside potential on the sale of the property.

**4. *The Superiority of the Commitment to Auction as an Insurance Provider Undercuts this Justification for the Existence of Rights of First Refusal.*** The commitment to auction is simply an analytical invention. I am unaware of the use of such a device or anything similar in the contracting world. Nevertheless, given the simplicity of the device and the practical similarity to the dominant right of first refusal vehicle, it would be surprising that contracts had not migrated in this direction if bargaining breakdown insurance was, indeed, the primary rationale for rights of first refusal.<sup>100</sup>

## **V. SECOND PROPOSED JUSTIFICATION FOR RIGHTS OF FIRST REFUSAL -- INHIBITING EXIT**

As noted in Part III.A, the close corporation literature provides a number of reasons that participants would wish to restrict the free transferability of shares. Typical are suggestions that the participants may wish to have the power to choose their future associates, to block the entry of a bad actor, to maintain family control, or to control the number or identity of the shareholders to ensure tax and regulatory compliance.<sup>101</sup> Moreover, it has been suggested that investment by

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<sup>100</sup>None of the practitioners that I spoke with on the subject had ever encountered a contractual commitment to auction or anything similar. Their first impressions were that current users of rights of first refusal would not be interested in a commitment to auction as an alternative. I believe this attitude partially reflects the fact that often the primary purpose of a right of first refusal is to inhibit exit by co-venturers, as is discussed in the next Part, and partially reflects a discomfort with auctions in their conventional form.

<sup>101</sup>*See supra* notes 69-72 and accompanying text.

the rightholder may be facilitated by restricting the transfer of the property to a third party with different plans.<sup>102</sup> The implication behind each of these justifications is that the participants are less concerned about a party leaving a venture than they are about the composition of the venture after a party has exited. This story implies that rights of first refusal are primarily about controlling who is to become a participant in a venture.<sup>103</sup>

But this cannot be a complete and accurate picture. As we have seen, a commitment to auction would serve the same purpose at a lower cost to the contracting parties. In this Part, I suggest that the central motivation behind most right of first refusal clauses, particularly in close corporation or co-venturer cases, is to inhibit exit. The participants genuinely may be concerned about the identity of new entrants, but the primary motivation must be to discourage participants from leaving. Focusing on co-venturing situations generally and on the close corporation in particular, this Part examines why contracting parties would wish to inhibit exit and why they would select the right of first refusal to accomplish this end. The following Part will question whether this explanation is persuasive in all contexts in which we observe rights of first refusal.

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<sup>102</sup>*See supra* note 74 and accompanying text.

<sup>103</sup>*See, e.g.,* O'NEAL & THOMPSON, *supra* note 3, § 7.26 (a “share transfer restriction is usually intended to keep strangers out of a close corporation”).

### **A. Why Co-Venturers Would Wish to Inhibit Exit**

In the close corporation scenario or, in fact, in any reciprocal arrangement, the participants may value stability within the membership highly. Although an auction guarantees the insiders the opportunity to purchase the interest of a departing member, the participants may prefer that no member departs. There are several possible reasons: At the time of sale the insiders may lack the cash to buy the departing member's interest, or, simply for diversification reasons, the insiders may prefer not to increase their investment in the venture.<sup>104</sup> The members may be less concerned about the disruption caused by the entry of a new partner than they are about the loss of the management skills of a departing partner.<sup>105</sup> Moreover, a high level of stability within the investment and management group may further facilitate investment by the participants.<sup>106</sup>

### **B. Why Co-Venturers Would Utilize a Right of First Refusal to Inhibit Exit**

At first glance the right of first refusal seems a clumsy mechanism for inhibiting exit. The right does not restrict alienability absolutely; it just adds a hurdle, the height of which will vary from case to case. If co-venturers really wanted to control alienation of interests, why did

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<sup>104</sup>See *supra* note 99 and accompanying text.

<sup>105</sup>O'Neal and Thompson suggest that the departure of a shareholder who performs an essential function may be disruptive, but their focus remains on the quality and compatibility of the replacement. See O'NEAL & THOMPSON, *supra* note 3, § 7.02.

<sup>106</sup>In Part III.A, I discussed the argument that rights of first refusal decrease risk and facilitate investment by the rightholder. The focus of that argument was on the risk that a new owner might have different plans for the property and refuse to renew a lease or to proceed with the plans of a close corporation. The risk I have in mind here is slightly different. Here, investment is facilitated by minimizing the risk that a highly valued partner may leave or that the remaining venturers will have to infuse additional cash into the venture to stave off disruptions.

they not simply contract for this result?<sup>107</sup> I believe there are two answers to this question. First, as practitioners confirm, the right of first refusal does an effective job of restraining transferability of interests, particularly in the close corporation situation. Second, the right of first refusal has become a legally acceptable means of discouraging sales, and courts traditionally hostile to restraints on alienability have tended to invalidate more obvious restrictions.

*1. Fitness of the Right of First Refusal for Inhibiting Exit.* Like a direct bar on alienability, a right of first refusal imposes no direct costs on any participant in the venture until a member seeks to sell his interest. Unexercised rights cause no reduction in cash flow or income. Moreover, if the group makes a collective decision to sell or to allow one or more participants to sell their interests unencumbered, the group can agree to remove the share transfer restriction. Thus, the instrument serves as a form of financial handcuffs, depressing the realization of any partner who decides to exit unilaterally.

The effectiveness of the handcuffs in any particular case depends on the impact of the instrument on third-party bidders. As demonstrated in Part II, this impact will be a function of the number of likely bidders, the relative uniqueness of the property, and the potential for high insider idiosyncratic value. At the time of contracting, of course, the participants will not be able to predict how effective a restraint the right of first refusal will be, but practitioners indicate that in the close corporation setting, at least, the right of first refusal generally stymies sales to outsiders.<sup>108</sup>

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<sup>107</sup>If allowed full freedom of contract, shareholders of a close corporation could contract for a majority, supermajority, or unanimous vote requirement to permit the sale of any shares.

<sup>108</sup>*See supra* note 62 and accompanying text. It may be that close corporation participants who do not know *ex ante* whether they will be a buyer or a seller of the interests of their firm in

**2. *Judicial Hostility to Restraints on Alienability.*** Historically, courts have been suspicious or even openly hostile to restraints on the free alienability of shares.<sup>109</sup> Invoking common law norms favoring the free transferability of personal property, some late-nineteenth-century courts held rights of first refusal to be unreasonable restraints.<sup>110</sup> Judicial attitudes have evolved in the past century, however, and most states have now adopted statutes expressly authorizing rights of first refusal and similar share transfer restrictions. These statutes do not grant corporations or their shareholders complete freedom to restrict transfers, however, and they often subject certain types of restrictions to a reasonableness test.<sup>111</sup> Today, share transfer restrictions are seldom invalidated outright, as close corporation agreements have come into line with the statutory safe harbors or liberalized judicial precedent validating certain restrictive practices. Nonetheless, a continuing inclination to construe such restrictions narrowly persists.<sup>112</sup>

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the future do not want to adopt an absolute restriction on transfer, or to leave the question to a future vote. They may prefer the option of exiting unilaterally, albeit at a significant discount to going concern value. The argument remains, however, that the participants must favor the additional hurdle placed by the right of first refusal, or they would have opted for a commitment to auction.

<sup>109</sup>A full history and analysis of judicial hostility to restraints on the free alienability of shares is beyond the scope of this Article. This brief synopsis is taken from O'NEAL & THOMPSON, *supra* note 3, §§ 7.06-7.07, which fully recounts the evolution of judicial and legislative approaches to close corporation share transfer restrictions. *See also* CLARK, *supra* note 3, at 763-64.

<sup>110</sup>*See* O'NEAL & THOMPSON, *supra* note 3, § 7.09, at n.1.

<sup>111</sup>*See id.* § 7.06.

<sup>112</sup>*See id.* §§ 7.09, 7.36.

In this environment the right of first refusal has developed as the tool of choice for shareholders wishing to restrict the free transferability of interests within the close corporation.<sup>113</sup>

It seems likely that it is the very fact that a right of first refusal appears to be innocuous, but in practice acts as a serious restraint, that has made the instrument an ideal choice for continuity minded co-venturers. This conclusion is supported by the following passage from the most recent edition of *Corbin on Contracts*:

A contract that creates in B a Right of First Refusal for a definite period operates very little, if any, as a restraint on alienation by O. If O can find a buyer, O has the power to create a privilege to sell by merely offering to sell to B. If B accepts, a sale is consummated; if B does not accept, O is free to accept the buyer's offer. Although there is some authority otherwise, the preferable majority of courts hold that a right of first refusal is not an unlimited restraint on alienation and is not violative of the rule against perpetuities. *Rather than restraining alienation, the right enhances it by providing two buyers when property is sought to be sold.*<sup>114</sup>

The attitude reflected in *Corbin* and elsewhere is that the right of first refusal merely gives the insiders a “last look.” The seller is free to dispose of his shares at any time. But, as we have seen analytically and as practitioners report anecdotally, the right of first refusal significantly restricts alienability. Because a commitment to auction sufficiently guarantees the remaining co-venturers an opportunity to retain control of the property, it appears that the primary motive for the adoption of a right of first refusal is to inhibit insider exit.

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<sup>113</sup>*See id.* § 7.09 (“the form of option most likely to receive judicial support is a right of first refusal”).

<sup>114</sup>CORBIN, *supra* note 2, § 11.3, at 484-85 (emphasis added, footnotes omitted).

## VI. THE RIGHT OF FIRST REFUSAL OUTSIDE THE CO-VENTURING CONTEXT

A desire to inhibit exit and preserve the status quo seems a plausible explanation for the adoption of rights of first refusal by the shareholders of a close corporation or by other co-venturers, but this justification does not translate very well into the unilateral right of first refusal context. A lessee or franchisee, for instance, may have some interest in locking in the current relationship, but his power to do so is quite limited. It is conceivable that a tenant entering a lease may have less of an interest in acquiring the property midway through the lease term than in retaining his current landlord for the full term, and for that reason might prefer a right of first refusal to a commitment to auction.<sup>115</sup> However, this lock-in gain appears minimal since a successor landlord would be committed to continue the lease through its term, and the current landlord could sell the property unencumbered at the end of the lease.<sup>116</sup> At the least, then, we must supplement the status quo preservation explanation in the unilateral right of first refusal scenario.

This Part examines a number of alternative or supplemental explanations for the adoption of rights of first refusal in unilateral cases. Section A argues that the greater fungibility of some commercial property and the prospect of a large number of bidders reduce, but do not eliminate, the cost of the right of first refusal. Primarily because the parties must price the instrument in the unilateral case, Section B discounts inadvertence as a key factor in the right's adoption. Finally,

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<sup>115</sup>The right of first refusal would tend to discourage bidders and to reduce the landlord's realization on sale, thus inhibiting sale by the landlord within the term of the lease.

<sup>116</sup>Recall that the typical unilateral right of first refusal runs only for the term of the underlying arrangement, in this case the lease. *See supra* Part I.C.2.

Section C suggests that adoption of unilateral rights of first refusal may reflect an instance of suboptimal standardization of contract terms.

#### **A. Fungibility and the Number of Potential Third-Party Bidders**

The cost disadvantage to an owner of granting a right of first refusal to purchase a property, instead of committing to auction, may be minimal in the case of relatively fungible commercial property which would draw the interest of a large number of third-party bidders. As shown above, the cost of the right of first refusal arises from dissuading potentially high-valuing bidders. If the potential bidding universe included no more than one outside bidder, the instrument would not be more costly to the contracting parties than a commitment to auction.<sup>117</sup> Similarly, if a significant number of high-valuing outside bidders remain interested despite the right of first refusal, then the cost is negligible, particularly if the most highly valuing bidders persevere. Intuitively, one would expect that the bidders most readily discouraged by the right of first refusal would be the relatively lower valuing parties. Thus, if ten parties were interested before learning of the right of first refusal, and five withdrew thereafter, we might expect little reduction in the seller's potential realization.

The contracting parties face the largest risk in adopting a right of first refusal in cases in which a relatively small universe of potential bidders may be eliminated or reduced to one by the instrument. A relatively unique asset, such as close corporation shares, would appear to fall into this category, as bidders will be difficult to find for the shares in the best of circumstances. Some fungible commercial property, however, may more closely resemble the case in which ten potential bidders drops to five in the face of a right of first refusal. If at the time of contracting it

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<sup>117</sup>*See supra* Part II.C-D.

is at all predictable which category an asset will fall into, this phenomenon could help explain the persistence of rights of first refusal in some unilateral commercial property cases.<sup>118</sup>

This argument suggests that less of a status quo-preservation motivation is needed to justify the cost of a right of first refusal when a sizable number of third-party bidders can be expected in spite of the instrument. If, however, there is essentially no motivation to inhibit exit, as often will be the case in lessee/franchisee situations, why should the contracting parties accept even a small incremental cost given the option of committing to auction?

### **B. Inadvertence and Pricing the Right of First Refusal**

Because preservation of the status quo is less desirable and less feasible in unilateral right of first refusal cases, the instrument usually will be less important to the contracting parties than it is in the reciprocal context. One might be tempted to suggest, therefore, that the parties in the unilateral cases simply are not paying much attention to the provision. However, even if a term is relatively unimportant, we normally expect contract law to evolve to an efficient structure.<sup>119</sup> Moreover, the need to price the term in the unilateral context should draw the parties' attention to it.

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<sup>118</sup>A lessee or other grantee of a unilateral right of first refusal on fungible property also may be less likely to place idiosyncratic value on that property. *See supra* note 43 and accompanying text. Although this fact alone would tend to reduce the cost of the right of first refusal by dissuading fewer third-party bidders, the value of the right to the grantee is reduced as well. In this case the right of first refusal is simply less important. But the fact that the right is less important does not, without more, justify suboptimal contracting. By contrast, the argument above is that even if a rightholder places a high idiosyncratic value on a property (perhaps because goodwill is critical in a particular neighborhood business), the cost of the right is reduced if the property is sufficiently fungible to attract a number of high-valuing bidders.

<sup>119</sup>The next Section suggests, however, that suboptimal standardization of the right of first refusal term may have blocked evolution to the efficient term for unilateral contracts.

Although providing insurance to the rightholder, the right of first refusal decreases the expected realization from the sale of the property. Moreover, as I noted earlier, the instrument serves to shift value from the seller to the rightholder. Thus far, I have ignored this second effect, assuming that the parties to the right of first refusal contract can allocate any costs between themselves *ex ante*. Interestingly, cost allocation poses less of a problem for co-venturers than it does for lessors and lessees. In the case of co-venturers each participant grants and receives the right from the others. Cases may arise in which it appears likely that a particular partner will be the first to sell, but generally it will be anybody's guess as to who will assume the seller and rightholder roles. In the case of equal partners the value transfers offset one another, thus eliminating the need to price the instrument *ex ante*. The partners may all be worse off, but they are equally worse off.<sup>120</sup>

The unilateral grant of the right in the case of the lessor and lessee is more complex, however. A lessee may want to have a right of first refusal even if the possibility that the lessor will decide to sell during the lease term is remote. Unless the lessor believes the chance of sale is negligible, however, he should only grant the right if he can recover the expected cost through higher rent or other concessions from the lessee. Intuitively, one would think that the need to price the right of first refusal *ex ante* would tend to alert the parties to the unilateral contract to the costs, whereas this factor would tend to make the instrument more invisible to the reciprocating co-venturers. Of course, it is possible that the low probability of triggering and the relatively low cost in the unilateral case leads to nonchalant pricing. In other words, the grantor

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<sup>120</sup>Even if the interests held by the parties to a reciprocal arrangement are not equal, no pricing issue arises if we assume that the costs and benefits of the right of first refusal are proportional to the size of each party's interest.

may not evaluate the potential cost in any detail but may simply trade the right for a minor concession by the grantee.<sup>121</sup>

### C. Suboptimum Standardization of Contract Terms

If inhibiting exit does not motivate the adoption of rights of first refusal in most unilateral situations, one would think that in an efficient world the parties to these agreements would instead utilize a commitment to auction to provide low-cost insurance against bargaining breakdown, while co-ventures who desire continuity within their membership would continue to adopt rights of first refusal. The theory of network externalities and suboptimum contract standardization may best explain why such bifurcation has not occurred.<sup>122</sup> Contract drafters always face the options of formulating unique terms or adopting previously used provisions.

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<sup>121</sup>The “negotiation” in which Pabst Brewing Company granted Pincus, a senior executive, a right of first refusal on the sale of a subsidiary company he managed exemplifies the lack of thorough evaluation that often underlies these arrangements. Judge Cummings described the proceedings as follows:

At that time Pincus was president of Pabst’s non-beer subsidiaries, which included both PMP and PL. Negotiations for the sale of PL were still in progress when August U. Pabst, executive vice president of operations for the brewery that bears his family name, met with Pincus regarding his future with Pabst. The two men discussed an arrangement under which Pincus would resign as president of PL, but remain president of PMP and assist Pabst in negotiating the PL sale. Pincus’ salary and benefits would not change. Pincus asked Mr. Pabst if, as part of this arrangement, he could have a right of first refusal to purchase PMP, which manufactured and sold industrial fermentation products. After conferring briefly with William F. Smith, president and chief executive officer of Pabst, Mr. Pabst agreed to grant that prerogative to Pincus. Pincus’ attorney drafted a concise, one-page document, which was signed by both sides within hours after the meeting. *Pincus v. Pabst Brewing Co.*, 893 F.2d 1544, 1546 (7th Cir. 1990).

<sup>122</sup>*See generally* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting*, 83 VA. L. REV. 713 [hereinafter Kahan & Klausner, *Standardization*]; Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347 [hereinafter Kahan & Klausner, *Path Dependence*].

Adopting a standard term, however, allows the contracting parties to take advantage of past interpretations of that term. The parties also gain if future contracts adopt the same term and contribute to the wealth of interpretation and precedent.<sup>123</sup> The incentives to following standard terms are several.

**1. Drafting Efficiency and Effectiveness.** The adoption of industry boilerplate decreases the actual cost of constructing the document and reduces the chance of overlooking a contingency or allowing other errors to creep into the provision. Given the contingent nature of the right of first refusal, the investment that would be required to draft a commitment to auction may not be warranted. More importantly, although I have argued that the auction instrument is not conceptually very different from the right of first refusal, details of the commitment to auction would have to be worked through carefully to avoid ambiguities, provide for all contingencies, and ensure an error-free document. Moreover, even if the provision is expertly drafted, certainty is reduced until the device is used and litigated.<sup>124</sup>

**2. Judicial Precedent.** Given the historical hostility of courts to restraints on alienability and their continuing inclination to construe such restraints narrowly, the certainty-inducing value of precedents upholding specific right of first refusal provisions is particularly high. As courts now view rights of first refusal as relatively benign and as they are reinforced in that view by

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<sup>123</sup>See Kahan & Klausner, *Standardization*, *supra* note 122; Kahan & Klausner, *Path Dependence*, *supra* note 122. The authors refer to the benefits derived from past contracts as learning benefits and those from future contracts as network benefits. The categories of benefit discussed below follow from these articles.

<sup>124</sup>Analytically a commitment to auction is less restrictive than a right of first refusal. Nonetheless, the expected cost of a drafting error or overlooked contingency may be particularly high in constructing restraints on alienability given the courts' continuing inclination to construe such provisions strictly.

statutes expressly authorizing their use among shareholders, it is likely that the instrument will continue to be used and that more useful precedent will evolve.

**3. *Industry Familiarity.*** Rights of first refusal are familiar to business professionals. The full economic implication of these instruments often may not be thoroughly considered, but what they do, how they work, and the fact that they are accepted and acceptable are well understood. This familiarity reduces the associated cost of the future services of lawyers, bankers, and other professionals. Further, even if a potential buyer of the encumbered property must overcome the right of first refusal hurdle, at least the buyer is dealing with a known commodity. A commitment to auction may be less onerous, but its adoption would involve some investment in explanation and understanding. Perhaps most importantly, the right of first refusal is familiar to the other parties to the contract. Perversely, in my view, a lessee may find it easier to convince a lessor to grant a “boilerplate” right of first refusal than to adopt a newfangled commitment to auction.

**4. *Existing Diversity of Alienability Restraints.*** One problem with the suboptimum-standardization-of-contract-terms argument, however, is the need to explain the existing diversity in restrictions on alienability. Although rights of first refusal appear dominant, rights of first offer, commitments to negotiate, and variations on these devices abound. Why would diversity extend as far as it has but not evolve to encompass commitments to auction, if such commitments are indeed optimum for parties seeking to prevent bargaining breakdown in lease, franchise, and other unilateral situations?

We cannot be sure, of course. We can speculate that commitments to negotiate, for example, which do not effectively prevent bargaining breakdown, serve a very different niche in the contracting market than do rights of first refusal, and thus have had the critical mass

necessary to have generated an independent standard term. More generally, the theory presented above only asserts that standardization provides certain efficiencies. If the economics driving contracting parties to diversify is sufficient, the standardization compulsion will be overcome and diversity will result. As we have seen, however, the right of first refusal generally is less important in unilateral cases and the incremental cost imposed on the contracting parties is reduced. Here the driving force to diversify simply may be lacking.<sup>125</sup>

## VII. IMPLICATIONS

The primary goals of this Article have been to examine the economic effect of the right of first refusal and, by so doing, to explain the true purposes served by the device. I have few normative prescriptions for contracting in the private sector. Although family-held corporations cause one to pause, I believe that private contracting in the commercial sector is generally efficient. The first Section of this Part, therefore, is limited to a few thoughts on the flow of information and the possibility of overcoming network externalities in private contracting. I am less optimistic about the efficiency of contract terms imposed on parties by legislative mandate, however, and the second Section suggests that legislatures generally should refrain from mandating true rights of first refusal.

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<sup>125</sup>Kahan and Klausner also suggest that agency problems and cognitive biases may contribute to suboptimum standardization. *See Kahan & Klausner, Path Dependence, supra* note 122, at 353-65. An agency problem may arise if a risk averse attorney prefers the more certain boilerplate term to the riskier, although perhaps incrementally superior, uniquely drafted term. Unless a party to a right of first refusal is a frequent player, however, it is not clear that the client will be any less risk averse than his attorney. Cognitive biases that may figure into the standardization of suboptimum terms include status quo bias, a reluctance to depart from the norm; anchoring bias, the tendency of people to be influenced by reference points; and conformity bias, which reflects the influence of peers. The authors merely suggest these cognitive biases as possible supplemental explanations for suboptimum standardization, and I do the same.

## A. Private Contracting

Unless undermined by imperfect information, private contracts are presumed to be efficient.<sup>126</sup> Rights of first refusal are almost always negotiated among a limited number of parties, and, thus, information acquisition and processing should not be hindered by collective action problems.<sup>127</sup> Nonetheless, given the apparent innocuous nature of the term, it is important that each party realize that the right of first refusal provision is not harmless boilerplate. Practitioners have long realized the significance of the restraint created by the right of first refusal. Hopefully, this Article will assist lawyers in explaining the term and its impact to their clients.

Rather than automatically adopting a right of first refusal provision, contracting parties and their attorneys should consider the objectives to be served by the restriction. If continuity among the participants is an important goal of the contracting parties, as it often will be in close corporations, the right of first refusal may be a good fit. If, however, the parties prefer free transferability and simply seek to insure against bargaining breakdown, a commitment to auction should be considered. In many instances the significance of the provision will be insufficient to justify the crafting cost and incremental risk associated with the adoption of a unique term, but exceptions may arise.

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<sup>126</sup>Moreover, these efficient contracts are presumed to be socially optimal in the absence of externalities. See Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1404-07 (1989); Kahan & Klausner, *Path Dependence*, *supra* note 122, at 347. Aside from the network externalities discussed below, the right of first refusal does not appear to produce externalities. The additional cost incurred by the third-party bidder should be fully absorbed by the contracting parties.

<sup>127</sup>Compare the creation of the contract that is the public corporation's charter. Rationally apathetic investors will not assess every minor term of the charter, and other mechanisms must be relied upon to ensure efficient charter formation. See Bebchuk, *supra* note 126, at 1407.

As noted above, optimum private contracting may be hindered by network externalities. If rights of first refusal and their kin are entrenched and overused because of network externalities,<sup>128</sup> contract diversity could be facilitated by the promulgation of a model commitment to auction.<sup>129</sup> Legislatures could further assist private contracting by adding the commitment to auction to the list of permissible restrictive devices in state close corporation statutes, although, as we have seen, rights of first refusal may remain dominant in close corporation agreements due to the shareholders' preference for continuity in the membership.

### **B. Statutory Grants of Rights of First Refusal**

Given the deleterious but obscure impact of the right of first refusal on the value of encumbered property, the statutory grant of such rights is particularly troubling. If a legislature believes it necessary to provide any such protection, a commitment to auction should be utilized.

Although the large majority of rights of first refusal are created by private contract, it was noted in Part I that such rights increasingly are being granted by statute. While some may question the efficiency of contracting between private parties, there is not even the illusion of a market check on these public grants. Legislatures may believe that the rights they are granting

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<sup>128</sup>*See supra* Part VI.C.

<sup>129</sup>Although there can be no assurance of optimal contracting, a standard setting group promulgating model contract terms could promote a useful balance between uniformity and diversity of terms. Compared with the creation of unique terms, private contracting parties adopting model terms face reduced development costs and lower risks of formulation error. *See* Kahan & Klausner, *Standardization*, *supra* note 122, at 762. In the case of suboptimum technological standards reached through path dependent behavior, unwinding the standard *ex post* can be inefficient. A different standard or diverse standards might be socially superior, but given a sizable installed base switching costs may outweigh the inefficiency. Because contract term efficiencies are less dominated by external effects, one suspects that diversity generally could be injected into suboptimally uniform contract terms without negative effects.

are innocuous or that they only transfer value from grantor to grantee. Thus, providing a right of first refusal may seem like a cheap way of satisfying a disgruntled constituency. As the following examples demonstrate, however, where true rights of first refusal are mandated, this assumption may be quite mistaken.

**1. Condominium Conversion Statutes.** Some statutory rights of first refusal cause little economic harm. The rights associated with condominium conversions usually fall into this category.<sup>130</sup> Although the term “right of first refusal” is invoked, the typical statute creates a right of first offer in which the owner proposes a price to the rightholder. Generally, after giving the tenants a certain term to purchase, these statutes place a short term moratorium (perhaps 90 days) on the sale of a unit to the general public for less than the price offered to tenants. The statute certainly limits the owner’s freedom of alienation, but, assuming the owner can reject financially unqualified applicants, the real burden is minimal. If the owner wishes to negotiate with third parties below the list price offered to tenants, the owner need only make the offer to the tenants well before he plans to go public. At most, the statute delays the owner for a few months.<sup>131</sup>

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<sup>130</sup>See, e.g., VA. CODE ANN. § 55-79.94 (Michie 1997).

<sup>131</sup>Two other statutory right of first refusal grants that appear toothless, but if written more tightly could have been quite onerous, are the Petroleum Practices Marketing Act, 15 U.S.C. § 2802 (1997), and a Florida statute regulating the sale of mobile home parks, FLA. STAT. ANN. § 723.071 (West 1997). The Petroleum Marketing Practices Act [PMPA] governs the relationship between gas station franchisors and franchisees and places restrictions on the termination and nonrenewal of certain franchise agreements. Certain agreements must be renewed unless one of the enumerated grounds for nonrenewal is met. Most of the grounds involve franchisee misconduct, but sale of the premises is another valid ground for nonrenewal if the franchisor either 1) makes a good faith offer to sell the station to the franchisee or 2) provides a right of first refusal on an offer received from a third party and the franchisee declines to purchase on the terms offered. Franchisors wishing to sell should not be seriously hindered by this statute. Essentially, a franchisor desiring to sell one or more stations would be in the same

For a number of reasons a true right of first refusal or even a commitment to auction would be particularly onerous in the condominium conversion scenario. First, buyers of residential real estate are unaccustomed to dealing with such instruments, and most potential buyers would not accept the time delay without a significant discount. Second, unless the right was particularized to a single unit, numerous tenants would have the right to match the offer, and some priority mechanism would have to be developed. Finally, the costs of managing such rights on numerous, relatively small transactions would be preclusive.

**2. *Rights of First Refusal on Foreclosed Farm Property.*** The legislatures of a number of midwestern states have granted rights of first refusal to the former owners of foreclosed farms.<sup>132</sup> Although some of these statutes are ambiguous and may be circumvented,<sup>133</sup> others expressly require a lending institution in possession to follow the classic right of first refusal

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position as the apartment owner described above. The franchisor must make a good faith offer to the franchisee, but if this offer is rejected the property is unencumbered. If the franchisor receives an unsolicited but acceptable offer from a third party despite the right of first refusal, all the better. He accepts the price from his franchisee or the third party. The statute is more problematic for the owner of a network of stations who wishes to fashion an attractive package deal. That franchisor must make individualized offers to his franchisees and accept the fact that the package will not include any stations are purchased. Nonetheless, the right of first refusal provision in the PMPA is not terribly onerous.

As interpreted, the Florida statute granting mobile homeowners' associations rights of first refusal on the sale of their parks is even more toothless. First, as in the condominium conversion case, the primary requirement is that an owner wishing to sell first must offer the park to the association, and the owner is then prohibited from "offering" below that price without retriggering the right of first refusal. Second, the owner is only obligated to notify the association before accepting an unsolicited offer for the property. Although it seems absurd that an offering owner could accept a lower counteroffer without retriggering the right of first refusal in the association, given the second provision, this point is far from clear. *See also*, Keenan, *supra* note 3.

<sup>132</sup>*See, e.g.*, IOWA CODE ANN. § 654.16 (West 1997). *See also* Houser, *supra* note 3 (reviewing and criticizing state statutes); Lawless, *supra* note 3 (reviewing state statutes and criticizing procedural debtor relief generally).

steps in disposing of the property. In other words, the bank is required to negotiate a price with a third party, transmit that offer to the former owner, and sell to the former owner on those terms if the former owner so elects. The bank may consummate the sale to the third party only if the former owner declines to exercise his right. Such a statute transfers value from bank to farmer and depresses the expected value of the farmland in a sale, and this appears to be a case in which the impact of the right of first refusal is significant. Farmland in general is fairly fungible, but failed farms are likely to lack economies of scale or be otherwise disadvantaged. Thus, the number of uninhibited bidders interested in foreclosed property may be small to begin with and the impact of dissuading bidders significant. As in the close corporation example, then, the result may be to severely restrain alienation, or in this case to confine the bank to resale to the former owner, at least in those cases in which the former owner can raise sufficient funds.

Perhaps this result is exactly what the legislatures intended. The legislative histories speak generally of concern for the welfare of farmers and preservation of family farms, and some of these states have enacted more serious restraints on alienation in the past, such as moratoria on foreclosures. However, if the legislatures were attempting to avoid the inevitable effect of severe restraints, such as tighter lending policies and higher loan rates, and simply ensure that the farms would not be sold to third parties without the former owner having an opportunity to repurchase, mandating a commitment to auction would have been a superior method to achieve that goal.

### CONCLUSION

Rights of first refusal are costly to the contracting parties. At the time of sale a third party may place the highest value on the encumbered property. By reducing a third party's expected gain and thus deterring potential outside bidders, the instrument reduces the seller's realization

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<sup>133</sup>See Houser, *supra* note 3, at 907-14.

potential. The impact is most significant when, as in the case of close corporation shares, the property is relatively unique, an insider is likely to place an idiosyncratic value on the interest being sold, and third-party bidders would be scarce even without such a restriction.

Rights of first refusal do avoid the possibility of a breakdown in bargaining between a seller and an inside bidder. Often where we encounter rights of first refusal both the risk and potential cost of such a breakdown are high. The potential cost is great because, at the time of the sale, an insider may place a very high value on the property. The risk of breakdown is high due to the likelihood of strategic bargaining, equity barriers, asymmetric information as to the magnitude of the insider's idiosyncratic value, and soured relationships.

If the parties simply seek to insure against bargaining breakdown, however, the adoption of a right of first refusal carries too great a cost. The same insurance can be provided at a lower cost by adopting a commitment to auction the property. An auction device can be designed that is surprisingly similar to the right of first refusal in implementation, that guarantees that an insider will prevail if he places the highest value on the property, but that also levels the playing field for outside bidders. We cannot measure the cost differential between the right of first refusal and the commitment to auction, but if the goal is simply to insure against bargaining breakdown, why would the parties accept *any* additional cost?

I have argued that there must be another goal, that the contracting parties, particularly in reciprocal arrangements, want to discourage each other from unilaterally exiting the venture. The participants do not simply want the option to buy the interest of a departing member; absent mutual agreement, they prefer that no one leaves. Depressing the potential realization of a party that is considering selling out places a hurdle on exit which may be quite significant in the case of a close corporation or other reciprocal relationship. The right of first refusal, then, serves as a

serious, but somewhat veiled, restraint on alienation that is acceptable to the parties, to the courts, and to legislatures. Although this explanation seems persuasive in the co-venturing context, it is less compelling in the context of unilateral grants of rights of first refusal, where the desirability and feasibility of locking the participants into the venture often are lacking. Here something of a mystery remains, but I have suggested that the incremental cost of the right of first refusal is less in the case of unilateral grants and may be insufficient to overcome network externalities.

Normatively, I see no reason not to defer to the informed contracting preferences of private parties adopting rights of first refusal or similar restraints. If parties wish to bind themselves to the continuation of an enterprise, they should be free to do so. However, I hope that this Article will add to a fuller understanding of the impact of the right of first refusal device, and will encourage attorneys and their clients to consider whether adopting this boilerplate term best serves the parties' intended purpose or whether a less costly commitment to auction would suffice. I have argued that legislatures should be particularly cautious in granting rights of first refusal and should consider requiring paper auctions instead, if the legislative goal is merely to ensure that a certain party has a fair opportunity to bid. We should question the rationale behind legislative decisions that go further and mandate true rights of first refusal.

## Appendix -- Bidder's Expected Gain at Auction and Under Right of First Refusal

General Assumptions:  $V_B=100$ ,  $V_{RH}(\text{mean})=100$ ,  $V_{RH}(\text{std. dev.})=5$ ,  $V_{RH}$  is normally distributed.

**Auction**      Assumptions: Bidding in increments of 1, Bidder begins at 81.

<u>Bidder's Bid</u>	<u>Gain on Success</u>	<u><math>V_{RH}</math> of Success</u>	<u><math>V_{RH}</math> Std. Dev.</u>	<u><math>V_{RH}</math> Prob.</u>	<u>Bidder's Gain X Prob.</u>
81	19	<82	<3.6	.00016	.00304
83	17	82-84	3.2-3.6	.00053	.00901
85	15	84-86	2.8-3.2	.00187	.02805
87	13	86-88	2.4-2.8	.00564	.07332
89	11	88-90	2.0-2.4	.01455	.16005
91	9	90-92	1.6-2.0	.03205	.28845
93	7	92-94	1.2-1.6	.06027	.42189
95	5	94-96	0.8-1.2	.09679	.48395
97	3	96-98	0.4-0.8	.13272	.39816
99	1	98-100	0.0-0.4	.15542	.15542
<b>Expected Gain:</b>					<b>2.02 or 0.4 sigma</b>

### **Right of First Refusal**

Procedure: Select bid that maximizes product of probability of success and gain.

<u>Bidder's Bid</u>	<u>Gain on Success</u>	<u><math>V_{RH}(\text{mean})</math> - X sigma</u>	<u>Prob. of Success</u>	<u>Bidder's Gain X Prob.</u>
96	4	.80	.21186	.84744
96.05	3.95	.79	.21476	.84830
96.1	3.9	.78	.21770	.84903
96.15	3.85	.77	.22065	.84950
96.2	3.8	.76	.22363	.84979
<b>96.25</b>	<b>3.75</b>	<b>.75</b>	<b>.22663</b>	<b>.84986</b>
96.3	3.7	.74	.22965	.84971
96.35	3.65	.73	.23270	.84936
96.4	3.6	.72	.23576	.84874
96.45	3.55	.71	.23885	.84792
96.5	3.5	.70	.24196	.84686

**Probable gain maximized at  $V_{RH}(\text{mean})$  - .75 sigma; 23% chance of success; expected gain of .85.**