

DRAFT Discussion Paper

Right of First Refusal (ROFR) contract provisions

November 12, 2013

**Overview:**

At its February 2013 meeting, the Council considered six separate actions that would modify various aspects of the right of first refusal provisions created to benefit community interests under the Bering Sea and Aleutian Islands crab rationalization program (Program). To protect community interests, the Program required holders of most processor shares to enter into agreements granting community-designated entities a right of first refusal on certain transfers of those shares. Since implementation of the Program in 2005, community representatives and fishery participants have suggested that some aspects of the rights of first refusal may inhibit their effectiveness in protecting communities. To address these shortcomings, the Council elected to modify current provisions with respect to three of the six actions (Action 1, Action 2, and Action 5).<sup>1</sup> Under Action 1, the Council recommended that the time available for a community entity to exercise a right of first refusal be increased from 60 days to 90 days, and the time for a community entity to perform under the contract be increased from 120 days to 150 days. Under Action 2, the Council recommended: (1) removal of an existing provision that states the rights lapse if a processor uses its share allocation outside the protected community for three consecutive years, and (2) creation of a new right of first refusal in the event a community fails to exercise the right, once it is triggered. Under this second provision, the processing share holder would designate the community entity that will be the holder of the right. Under Action 5, the Council recommended the creation of several notice requirements from the processing share holder to the right holder and NOAA Fisheries. These notices are intended to ensure the rights have their intended effect by providing better information concerning the use of the processing shares and the status of the right.

The Council elected to maintain the status quo with respect to Action 3 and Action 4. Under the status quo, the rights of first refusal apply to all assets in a transaction that includes processor shares subject to the right of first refusal and processor shares may be used in any location (subject to any applicable regional use restrictions). With Action 3, the Council considered alternatives that would have applied the right to either: (1) the processor shares only or (2) the processor shares and assets based in the protected community. With Action 4, the Council considered alternatives that would have required community entity consent for any use of processor shares outside of the community that is protected by the right. Although the Council decided to maintain the status quo on Actions 3 and 4, it suggested that it may be receptive to changes if stakeholders reached a consensus on appropriate measures.

During staff tasking at its June 2013 meeting, the Council received public testimony from some community right holders in regards to the Council's February 2013 decision on Actions 3 and 4. These right holders indicated that PQS and ROFR holders were considering the use of private contractual agreements to address remaining community protection issues, including contractual provisions that

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<sup>1</sup> The Council elected to take no action on Action 6, which would have allocated up to 0.55 percent of the Bristol Bay red king crab processing quota share pool to the Aleutia Corporation (a right holding entity) to address a grievance concerning a right of first refusal that it formerly held on shares in that fishery. The Council urged the parties to that dispute to work to resolve their issues prior to further Council consideration of the matter at a future meeting.

would limit the assets to which the right of first refusal would apply, and asked the Council to clarify whether flexibility exists for private contractual agreements that may contain provisions that differ from the required ROFR contract terms. In response to this testimony, the Council requested that staff prepare a discussion paper examining this question.

**Discussion:**

Further discussion of this issue involves a combination of logic, legal, and policy considerations. Previous analyses (the original analysis of community protection provisions from August 2004, and the February 2013 analysis of specific ROFR provisions) noted the tradeoffs between community protection and interests of the processor entity, as well as overall efficiency in the fisheries. These analyses also described the generally accepted definition of ROFR – i.e., a ROFR generally provides an entity with the right to purchase an item from a seller for the same price and subject to the same terms and conditions as offered by the seller in an open market. To use a simplistic example, if a seller is offering a car for \$1,000, the ROFR holder typically could not elect to buy the car for \$800, or elect to only purchase the tires for \$200. In 2004 the Council adopted the recommendations of its Community Protection Committee, which attempted to strike a reasonable balance of community and industry interests. Those provisions are also now in the crab FMP, pursuant to Section 313(j) of the MSA, and include the following (A through I):

Contract Terms for Right of First Refusal based on Public Law 108-199

- A. The right of first refusal will apply to sales of the following processing shares:
  - 1. PQS and
  - 2. IPQs, if more than 20 percent of a PQS holder's community based IPQs (on a fishery by fishery basis) has been processed outside the community of origin by another company in 3 of the preceding 5 years.
- B. Any right of first refusal must be on the same terms and conditions of the underlying agreement and will include all processing shares and other goods included in that agreement.
- C. Intra-company transfers within a region are exempt from this provision. To be exempt from the first right of refusal, IPQs must be used by the same company. In the event that a company uses IPQs outside of the community of origin for a period of (two options):
  - 1. 3 consecutive years
  - 2. 5 consecutive yearsThe right of first refusal on those processing shares (the IPQ and the underlying PQS) shall lapse. With respect to those processing shares, the right of first refusal will not exist in any community thereafter.
- D. Any sale of PQS for continued use in the community of origin will be exempt from the right of first refusal. A sale will be considered to be for use in the community of origin if the purchaser contracts with the community to:
  - 1. use at least 80 percent of the annual IPQ allocation in the community for 2 of the following 5 years (on a fishery by fishery basis), and
  - 2. grant the community a right of first refusal on the PQS subject to the same terms and conditions required of the processor receiving the initial allocation of the PQS.
- E. All terms of any right of first refusal and contract entered into related to the right of first refusal will be enforced through civil contract law.
- F. A community group or CDQ group can waive any right of first refusal.

- G. The right of first refusal will be exercised by the CDQ group or community group by providing the seller within 60 days of receipt of a copy of the contract for sale of the processing shares:
1. notice of the intent to exercise and
  2. earnest money in the amount of 10 percent of the contract amount or (two options)
    - a. \$250,000 or
    - b. \$500,000whichever is less

The CDQ group or community group must perform all of the terms of the contract of sale within the longer of:

1. 120 days of receipt of the contract or
  2. in the time specified in the contract.
- H. The right of first refusal applies only to the community within which the processing history was earned. If the community of origin chooses not to exercise the right of first refusal on the sale of PQS that is not exempt under paragraph D, that PQS will no longer be subject to a right of first refusal.
- I. Any due diligence review conducted related to the exercise of a right of first refusal will be undertaken by a third party bound by a confidentiality agreement that protects any proprietary information from being released or made public.

Notably, provision B states that “*Any right of first refusal must be on the same terms and conditions of the underlying agreement and will include all processing shares and other goods included in that agreement*”. This appears consistent with the generally accepted definition of ROFR as described above. It also appears consistent with the original analyses prepared for this issue, in 2004. Among other things that analysis noted that “*paragraph B provides that the ROFR would apply to the transaction involving processor shares as a whole and would require the community group exercising that right to agree to all the terms of the agreement. This provision would be intended both to make the ROFR workable and to limit the disruption to a processor’s transaction that might be caused by the exercise of the ROFR....exercise of the right would require the community group to perform the contract in its entirety. The requirements of the contract should be clear to the community. The provision is thought to protect the selling processor’s interests by requiring that the transaction that is acceptable to the processor be adopted*”.

That analysis also noted that the provision could limit the effectiveness of the right from the perspective of the ROFR holder. For this reason, additional options were developed by the Council and analyzed in the February 2013 ROFR amendment package including (1) applying the ROFR to the processor shares only or (2) applying the ROFR to the processor shares and assets based in the protected community. Based on the 2013 analysis, both of these options posed significant process, timing, cost, and administrative difficulties, including determination of a process for defining “*assets based in a community*”, and a process for mutually agreeable valuation of PQS in the scenario where PQS is separated from other assets in the sale. For these reasons the Council chose not to take action deviating from the status quo.

It is critical to the discussion at hand to understand whether and how a ROFR is triggered in the case of crab PQS. A ROFR situation only exists when and if there is an *underlying agreement* between a seller and a third (non-ROFR) party, and that agreement intends to take the underlying PQS out of the community or origin. If a PQS holder simply announces that PQS (and potentially associated assets) are for sale on the open market, and there does not exist an *underlying agreement* (contract) with another

party, then there is no ROFR triggered, and therefore no restrictions exist on contract provisions which may be negotiated and agreed to by the seller and a ROFR entity. If during this process the seller does develop an agreement with a potential third (non-ROFR) party, at that point the ROFR would be triggered.

In the presence of an underlying agreement as described above, a ROFR is triggered and the eligible ROFR entity is entitled to exercise its right to that deal, as stipulated in provision B (under the same terms and conditions). I could be argued, logically, that this provision was intended to protect the interests of the seller, and therefore it should be the seller's prerogative to alter the terms and conditions for the ROFR entity. However, provision B does not require them to do so, and in fact, on its face, requires the transaction to be completed on the same terms and conditions as the existing, *underlying agreement*. On its face, the question posed to the Council in Attachment A appears to be a simple "No". Unless the regulations are amended in some manner, provision B does not provide for a re-negotiation of the terms and conditions of the *underlying agreement*.

However, there does not appear to be any prohibition on a ROFR entity and a PQS seller negotiating a separate agreement, which would provide the ROFR entity some remuneration for NOT exercising its ROFR right. However, there appears to be no compelling incentive for the PQS seller to do so. If the *underlying agreement* only refers to PQS, and does not refer to 'other goods' (as stipulated in Provision B), then the ROFR holder would have the ROFR option on the PQS, and 'other goods' would be the subject of a separate contractual agreement.

Simply amending the FMP to alter provision B, which is allowed under Section 313(j)(3) of the MSA, (for example, to allow flexibility for the ROFR entity and the seller to negotiate an agreement which has different terms and conditions than the *underlying agreement*), would not appear to provide any compelling incentive for the PQS seller to do so, unless there were specific provisions included which required the PQS seller to negotiate towards the contract terms desired by the ROFR holder. Defining or quantifying the degree to which a potential PQS seller must re-negotiate would likely be a challenging policy determination. However, simply amending the FMP to allow for such a re-negotiation would provide for that possibility.