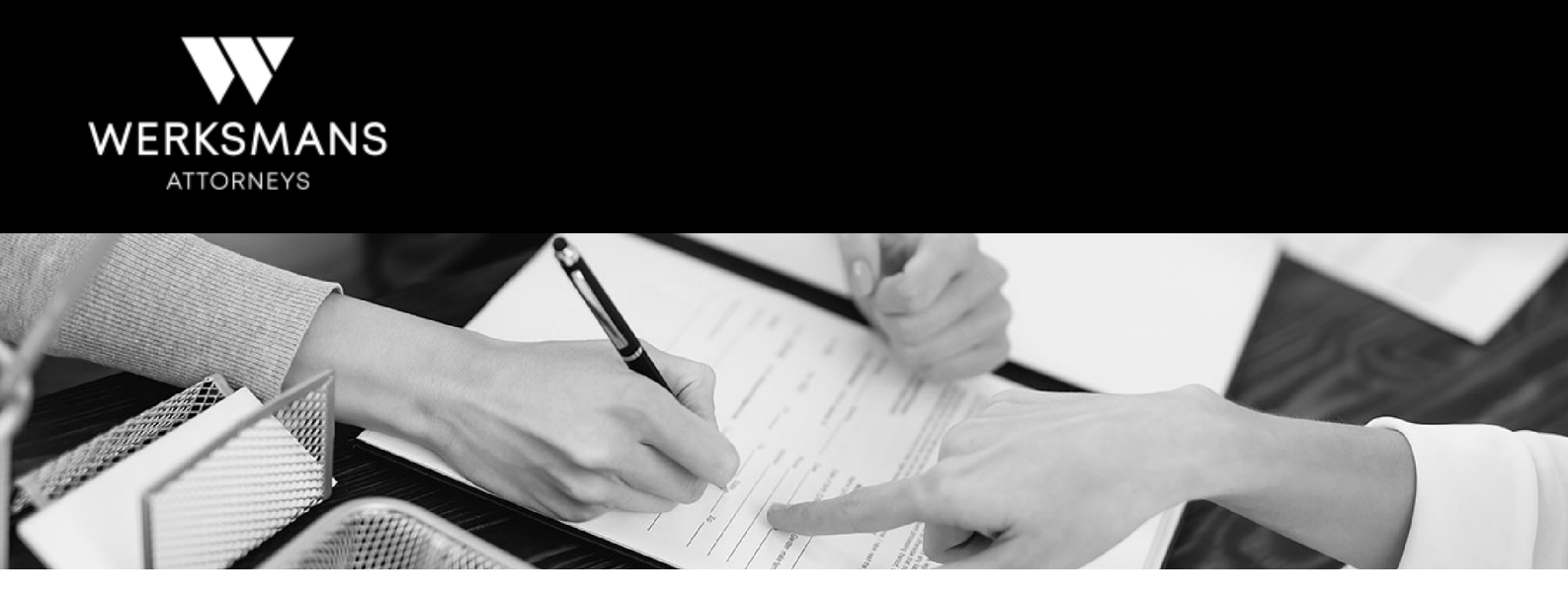




# ROFR vs ROFO: Navigating Restrictions on the Transfer of Shares in Private Companies

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## ABSTRACT

A memorandum of incorporation ("**MOI**") is a company's constitutional document which, amongst other things, governs shareholder rights and obligations. Under the Companies Act, 2008, a private company's MOI must restrict the transferability of its shares. This can be achieved by providing for a Right of First Refusal ("**ROFR**") or a Right of First Offer ("**ROFO**") in a company's MOI. A ROFR allows remaining shareholders to match external offers, thereby enabling remaining shareholders to preserve control over the shareholding structure of a company. In contrast, whilst a ROFO requires shares to be offered internally to remaining shareholders in the first instance, it provides more flexibility for a selling shareholder and reduces the control which the remaining shareholders are able to exercise over the ownership of the company. This article explores the inclusion of a ROFR versus a ROFO in a company's MOI.

## 1. INTRODUCTION

The Companies Act, No. 71 of 2008 ("**the Companies Act**") requires that a private company's Memorandum of Incorporation ("**MOI**") must restrict the transferability of the shares in such a company. This can be achieved through various mechanisms, such as providing for a right of first refusal ("**ROFR**") or a right of first offer ("**ROFO**") in the company's MOI. While both of these types of clauses regulate the sale and transfer of shares, they operate differently as regards the impact which they have on (i) the control exercised by remaining shareholders, (ii) the attractiveness of an acquisition of shares in the company for third-party purchasers and (iii) the bargaining power held by the selling shareholder. This article explores how ROFR and ROFO provisions operate, and some of the factors to consider when deciding on which contractual mechanism to include in a company's MOI.

## 2. THE MOI OF A COMPANY

In very simple terms, one can think of the MOI as a company's constitution. It is a binding legal document which, at the very least, sets out the rights, duties and responsibilities of the shareholders, directors and other stakeholders of the company, and regulates the relationship between the company and its shareholders, the relationship between the respective shareholders, and the relationship between the company and its directors.

The importance of the MOI of a company is often overlooked in the early stages of a company, however, a well-crafted MOI can play an instrumental role in carefully balancing the interests of the various stakeholders, mitigating certain risks and facilitating growth and external investment. The decision on whether to include a ROFR or ROFO in the MOI of a company is a strategically important aspect to consider at the outset.

## 3. RESTRICTION ON THE TRANSFERABILITY OF SHARES

Section 8(2)(b)(ii) of the Companies Act stipulates that the MOI of a private company must (a) prohibit the company from offering any of its shares to the public and (b) restrict the transferability of its shares.

### 3.1 A right of first refusal

A common contractual provision used in an MOI to restrict the transferability of shares in a private company is a ROFR which is drafted in favour of the remaining shareholders.

The effect of a ROFR is that, should a shareholder wish to sell its shares ("**selling shareholder**") and if it has received an offer from a potential purchaser ("**third-party purchaser**") on terms and conditions that the selling shareholder is willing to accept ("**external offer**"), the selling shareholder must first offer its shares to the remaining shareholders in the company (often in proportion to their current shareholding) on the same terms and conditions as those contained in the external offer.

The remaining shareholders will then have a prescribed period during which they can elect to accept or decline the offer from the selling shareholder. If the remaining shareholders accept the offer, then the shares of the selling shareholder will be sold to them on a pro rata basis and the third-party purchaser will be precluded from purchasing those shares. If the remaining shareholders decline the offer from the selling shareholder, then the selling shareholder may proceed to sell its shares to the third-party purchaser on the terms and conditions of the original offer presented by the third-party purchaser.

Even though the inclusion of a ROFR in a company's MOI is commonplace, and is an acceptable mechanism to limit the transferability of shares in the company, it may deter third parties from undertaking a process to acquire shares in the company. This is so because third parties may be reluctant to expend time, energy and money to do a due diligence on the company and to negotiate a transaction with the selling shareholder if they know that remaining shareholders will have the right to step in and "snap up" their carefully negotiated offer at the end of such process.

One of the other issues that can arise is that the remaining shareholders may seek to challenge whether the external offer is genuine i.e. the remaining shareholders may assert that the selling shareholder has procured a "non-genuine" external offer with an inflated offer price from a related party or other party, with the aim of achieving a sale to the remaining shareholders at a price which is higher than the fair value of the shares. Such an issue may delay the transaction, result in disputes and ultimately lead to additional hurdles for negotiations between the selling shareholder and the remaining shareholders (on the one hand) and between the selling shareholder and the third-party purchaser (on the other hand).

If the remaining shareholders do not exercise their ROFR, it should be noted that the shares may only be sold by the selling shareholder to the third-party purchaser on the same terms and conditions as the external offer received from the third-party purchaser. The selling shareholder is in a relatively weaker bargaining position because of the manner in which a ROFR operates because a ROFR establishes a price ceiling at the outset (i.e. being the price offered by the third-party purchaser) and the selling shareholder does not have any bargaining power to depart from that price in its dealings with either the remaining shareholders or with the third-party purchaser (in the event that the remaining shareholders do not exercise their ROFR).

A ROFR is a useful mechanism where the remaining shareholders want greater control over ownership, as is often the case with "founder" shareholders. However, as discussed above, it is less advantageous to a selling shareholder whose bargaining power and ability to negotiate and receive more favourable external offers is limited by a ROFR.

### 3.2 A right of first offer

An alternative to a ROFR, which is an equally acceptable mechanism to limit the transferability of shares in a private company, is a ROFO in favour of the remaining shareholders.

The effect of a ROFO is that should a selling shareholder decide to sell its shares, it must first notify the remaining shareholders of its intention to do so, before seeking any external offers. The remaining shareholders are afforded the opportunity to make offers to the selling shareholder within a prescribed period ("**internal offers**"), as opposed to affording them an opportunity to react to the terms of an external offer from a third-party purchaser.

If a selling shareholder receives an external offer from a third-party purchaser prior to it commencing a ROFO process with the remaining shareholders, the selling shareholder is typically not obliged to disclose the terms and conditions of such external offer to the remaining shareholders, but may choose to do so to encourage the remaining shareholders to make internal offers at a higher price and on better terms and conditions.

Depending on the wording of the ROFO, it may be that the selling shareholder is not obliged to accept any of the offers made by the remaining shareholders and that the selling shareholder is permitted to "go out to the market" to attempt to negotiate and receive more favourable external offers from third-party purchasers.

A ROFO poses less obstacles for both the selling shareholder and a third-party purchaser. Firstly, because the third-party purchaser does not run the risk of expending time, energy and money on performing a due diligence on the company and on negotiating an offer which may ultimately be snapped up by the remaining shareholders exercising their ROFR. Furthermore, provided that the selling shareholder complies with the provisions of the ROFO, the selling shareholder is free to conduct private negotiations or a competitive bidding process amongst various potential third-party purchasers in such manner as to derive the highest possible price. These characteristics make a ROFO very attractive to private equity investors as it provides for a less restrictive process to achieve the sale of an investment, which is an important consideration for private equity investors who need to ensure that they are able to exit an investment within the time horizons envisaged in their investment mandate.

Therefore, a ROFO allows for increased flexibility during the negotiation process between the selling shareholder and a third-party purchaser, but is less advantageous to the remaining shareholders who have less opportunity to acquire the shares of a selling shareholder and consequently less control over maintaining the shareholding structure of the company.

## 4. CONCLUSION

As indicated above, restricting the transferability of shares in the MOI of a private company is a prerequisite in terms of the Companies Act. However, there are different contractual provisions which may be included in the MOI to achieve compliance with this requirement, such as a ROFR or a ROFO. From the perspectives of the selling shareholder, the remaining shareholders and third-party purchasers, each of these have their advantages and disadvantages.

When deciding whether to include a ROFR or a ROFO, a party should therefore consider the factors discussed in this article and should obtain advice from commercial attorneys who have the necessary expertise to advise on these matters.



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