Getting Preemption Right: Tips for Drafting Clear and Effective Preemption Right Provisions

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Introduction. Parties to joint ventures and other cooperative agreements often include a provision, often referred to as a "preemption right," that gives them the option to buy a co-party's interest before that interest can be sold to a third party. However, disagreements about their scope and application often have given rise to disputes, including in the oil and gas industry where such clauses are extremely common.

In a high-profile example of such a dispute, Debevoise successfully represented Hess with respect to preemption rights contained in the joint operating agreement of a significant asset, which dispute delayed *by over a year* the closing of a transaction at the parent level of Hess Corporation: Chevron's $53 billion acquisition of Hess. The arbitration among Hess, ExxonMobil and China National Offshore Oil Corporation ("CNOOC") illustrates how disputes over preemption rights can have significant and wide-ranging commercial consequences and the need for clear drafting of these provisions.

In this Debrief, we provide practical tips for drafting clear and effective preemption right provisions.

Overview of Preemption Rights. Preemption rights are found in a broad range of contracts, including joint venture, shareholder and licensing agreements and procurement contracts, across many sectors.

Sometimes referred to as "preferential rights" or "rights of first refusal," they are often in the form of a transfer restriction that grants parties to an agreement the right to "pre-emptively" purchase a co-party's interest before that stake can be sold to a third party. (While this Debrief refers primarily to the type of preemption right that is triggered *after* a sale has been agreed with a third party, allowing the co-party to intervene and purchase the interest at the agreed-upon sale price, another type of preemption right is the "right of first offer" or "right of first negotiation," which gives co-parties the right to make an offer or negotiate for the purchase of the interest before it can even be offered to a third party.)

Preemption right provisions tend to serve the same basic purpose of allowing current parties to increase their stake rather than an outsider. However, their exact scope and operation can vary widely. As such, a key decision for parties drafting preemption right provisions is determining which transactions should trigger preemption rights and which transactions should be exempt.

Preemption rights are usually triggered when a selling party attempts to transfer their interest directly to a third party. Many agreements also include a "change-in-control" provision, such that the preemption right would be triggered when a third party gains "control" of a party or one of its parent companies.

On the other hand, preemption right provisions often exempt direct and indirect transfers to affiliated companies, allowing internal corporate restructurings to take place without triggering the right. Other common carve-outs include those designed to prevent preemption rights from interfering with large-scale transactions, parent-level M&A or IPOs.

In practice, however, it can be difficult to craft a preemption right provision that effectively carves out the types of transactions that are not subject to the preemption right, especially in ventures that are expected to last many years. In some cases, even a preemption provision designed to be narrowly tailored to a single asset can inadvertently threaten a much larger deal—for example, a parent-level merger—if that asset is considered an important component of that deal. As a result, preemption clauses (especially change-in-control provisions) have become a common flashpoint in disputes.

Tips for Drafting Preemption Language. To minimize the risks associated with preemption rights contained in such agreements, parties negotiating and drafting these provisions should keep the following points in mind:

- ***Weigh the costs and benefits of including a preemption right in the first place***. Parties should bear in mind that preemption right provisions are reciprocal and have inherent costs to all parties involved. In particular, because preemption rights can restrict the transfer or sale of a given asset, they can impact not only its marketability but that of the associated businesses. At the same time, preemption rights have discrete benefits, most notably in affording joint venture partners some control over their collaboration partners.

- ***If a preemption right is included, clearly state its scope of application, including with respect to any carve-outs***, including:
  - when the preemption right is triggered, including precise definitions of "transfer" and "change in control";
  - the types of transactions, if any, that are carved out from its scope;
  - what happens if the preemption right is triggered, including how the stake would be valued, the timeline for exercising the right and other procedural steps; and
  - a clear and efficient dispute resolution mechanism in case there is a disagreement.
- ***Anticipate impact on transactions, especially at the parent level***. An asset-level preemption clause can complicate larger deals up the chain of ownership if it is not properly limited. For example, parties may wish to exempt transactions where the asset in question represents only a small percentage of the value of the overall transaction. Parties might also consider bespoke carve-outs that contemplate a specific future transaction. For example, parties sometimes choose to carve out IPOs or ultimate parent level transactions from the preemption right, so that a company can go public or undertake a corporate merger without triggering preemption rights across its portfolio of agreements at the asset level.

Debevoise lawyers are well versed in the drafting and negotiation of preemption right provisions, as well as disputes related to preemption right provisions. We are available to advise parties on contract negotiations, guide clients through transactions that might involve preemption rights, litigate preemption rights disputes, and provide trainings on best practices. In addition, if companies have in-house model agreements containing preemption rights, it may be worth reviewing these periodically to ensure they are up to date, clear, and will operate as intended.

Please do not hesitate to contact us with any questions.

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Catherine Amirfar
Partner, New York
1 212 909 7423
camirfar@debevoise.com

Conway Blake
Partner, London
+44 20 7786 5403
cblake@debevoise.com

Ezra Borut
Partner, New York
+1 212 909 7271
eborut@debevoise.com

Geoffrey P. Burgess
Partner, London
+44 20 7786 9075
gpburgess@debevoise.com

Mark W. Friedman
Partner, New York
+1 212 909 6034
mwfriedman@debevoise.com

Dietmar W. Prager
Partner, New York
+1 212 909 6243
dwprager@debevoise.com

Samantha J. Rowe
Partner, London
+44 20 7786 3033
sjrowe@debevoise.com

Patrick Taylor
Partner, London
+44 20 7786 9033
ptaylor@debevoise.com

Shreya Aren
Counsel, London
+44 20 7786 3040
saren@debevoise.com

Tatiana August-Schmidt
Associate, New York
+1 212 909 6378
taugustschmidt@debevoise.com

Jake Grandison
Associate, London
+44 20 7786 5477
jgrandison@debevoise.com

Michael Pizzi
Associate, New York
+1 212 909 6157
mpizzi@debevoise.com