CORPORATE MATTERS:
BREAKING UP SHOULDN'T BE SO HARD TO DO

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Tags
Corporate
Contract Law

We have found that clients typically have to be persuaded to think about what will happen if a commercial relationship does not work out. In this issue we will discuss break up provisions and what you should look for when entering a business relationship or other form of contractual obligation.

The problem of what happens if a relationship does not work out as planned can arise in many different legal contexts: (i) Landlord/Tenant – in some instances matters concerning lease renewal are not determined when the lease is signed, but rather, they are negotiated at the expiration of the term; (ii) Joint Venture/Partnerships – many joint ventures or partnership are set up in ways that make deadlock a distinct possibility; (iii) General Contracts – either party to a contract can breach the terms and conditions; (iv) Marriage Contracts – apparently 50% of these are breached by one of the parties (the cleanest resolution of these breaches one governed by a pre-nuptial agreement). When everyone is in a good mood the assets are divided, even when the last thing on anyone's mind is the division of assets.

In many ways, the issue turns on whether you want a court or arbitrator to decide on a major dispute that has arisen in a business relationship. Delaware law, for example, provides for judicial dissolution upon application by a member or manager of a limited liability company in circumstances where it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement.[71] A shareholder in a 50/50 Delaware corporation has a similar right,[72] although the standards are different. If the documents governing your relationship are silent or do not sufficiently cover dispute resolution, you could be left in the situation where a judge or arbitrator you don't know is deciding how to resolve a dispute between you and someone you do know – or at least you thought you did – and nobody should want that.

Obviously, due to the costs and time involved, it is a good idea to keep disputes out of court. When this cannot be completely achieved, we often advise clients to include an arbitration provision in governing documents where possible. If, as a last resort, an outside party is needed to resolve a dispute, arbitration is usually more cost efficient and timely. An expert in the field can be chosen and while it is still not entirely desirable to have someone else decide on the point, an arbitrator with

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[71] Delaware Limited Liability Company Act, DEL CODE ANN. tit. 6, §18-802.
[72] Delaware General Corporation Law, §273

industry experience may at least deliver a result that the parties can live with. The parties can choose an arbitrator at the outset or insert mechanisms in the agreement governing selection. If the parties cannot agree on an arbitrator, they may each choose one and have those two arbitrators select an impartial arbitrator.

The scope of the arbitration can also be limited in a number of ways. An example of this is known as "Baseball Arbitration," where the dispute may involve the determination of a "Fair Market Price" or "Fair Market Rent." The arbitration will be set up such that each party submits a written proposal, and, following a hearing, the arbitrator will choose one of the submitted proposals without modification.

Provisions can be included to limit possible areas of conflict. Transfer restrictions are an efficient way of doing this. A party that has made the decision to discontinue in a joint venture may decide to sell its interest. Depending on whom the purchaser is to be, this can lead to conflict. To avoid one party being in partnership with someone it considers undesirable or maybe even a competitor in another business, a selling party should be obligated to offer its co-venturer a "Right of First Refusal" on the interest being sold. If a party receives a bone fide offer to purchase its interest from an independent third party, his co-venturers should have the right to purchase the interest for the same consideration being offered. This enables a dissatisfied partner to leave the venture while enabling the remaining partners to potentially maintain their existing level of ownership. A similar method, not involving a proposed sale, is to insert predetermined actions in an agreement that will be considered "triggers," giving rise to the other party having a call option, at a predetermined price, on the interest of the party initiating the trigger. This, however, can be somewhat punitive and may result in the party initiating the trigger selling at a discounted price.

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Another method of resolving a deadlock that is a client favorite (more for its name than the result, as it favors deep pockets) is a Shotgun Buy/Sell. A party can initiate this buy/sell procedure in the event of a deadlock (deadlock events will be defined) by given notice of to the other party stating the amount the initiating party believes to be the value of the entity. The recipient of the notice at that point is either a buyer or a seller. The mechanics of the sale will be set out in the agreement. The harshness of this procedure can be tempered by having the entity valued by other means, whereby the recipient of the notice receives fair market value rather than a price determined by the partner initiating the procedure.

If this or any exit provision is included in the governing documents, the parties should consider and decide whether it is their intention that such remedy be exclusive and preclude a party from seeking judicial dissolution. There have been cases where the courts have judicially dissolved an entity notwithstanding the fact that the parties had specifically negotiated a buy/sell provision.[73] The court's reasoning was that the exit provision did not purport to be an exclusive remedy (*i.e.*, it did not require a dissatisfied member to break an impasse by using the exit provision rather than a suit for dissolution).

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[73] See *Haley v. Talcott 864 A.2d 86 (Del. Ch. 2004)*.

Where there is a deadlock, the buy/sell arrangement is probably the best solution. It allows one of the partners to continue the business, does not force the partners to continue the business notwithstanding the disagreement, and provides the departing partner with a fair value for his ownership interest.

It is also important for any exit provision to take into account other aspects of the business. For example, in the *Haley* case, the parties were 50/50 owners of the limited liability company and co-guarantors of the company's debt. The exit provision was silent as to the treatment of the debt if the buy/sell procedure was initiated. The court used this as another reason to bypass the exit provision and judicially dissolve the company.

In summary, whenever one is entering into a business venture consideration should be given to how to break a deadlock. If exit mechanisms are clearly worded and take into account all aspects of the parties' business, resorting, or being subject to, judicial dissolution with all its inherent costs and uncertainties can be avoided.