

CORPORATE MATTERS: ENDING A BUSINESS RELATIONSHIP – A TIME CONSUMING AND DRAWN-OUT PROCESS

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Tags

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INTRODUCTION

Often the realities of a business arrangement can be quite different than a plan conceived between optimistic partners. Market conditions can change, and commitments made can become difficult to deliver, sometimes through no lack of trying.

As business attorneys, we have seen situations where one partner brings technical and production know-how and another brings the promise of market introductions and sales contacts. If the contacts don't pan out and the product essentially sells itself, one partner may decide that it is better to go it alone.

This is just one factual scenario that may lead a joint venture partner to decide to end a partnership. Others include changes in personal circumstances and irreconcilable differences leading to a deadlock. The question we are then asked is "what is the best way to exit the partnership?"

FOUNDING DOCUMENTS

The first step in advising a client in this predicament is to review and understand the governance provisions of the founding documents.

Often, business partnerships like the one described above are in the form of a limited liability company. The operating agreement of a limited liability company covers the rights and obligations of the parties and sets forth governance and procedural requirements of the company. Before any other steps are taken, the operating agreement should be reviewed and a clear understanding gained as to the provisions relating to member withdrawal, transfer of ownership interests, and dispute resolution.

The thought of a breakup is not usually in the forefront of the partners' minds when these documents are prepared, and these types of provisions are often pretty standard. Care should be taken when drafting an operating agreement to include provisions that are helpful to the members should the need arise. More often than not we see agreements providing for no withdrawal or transfer of a member's interest or only allowing withdrawal or transfer with the consent of the other member. In a 50/50 partnership, those types of provisions are not very helpful when a dispute arises. Obtaining the consent of the other partner may not be realistic.

If the L.L.C. does not have an operating agreement or the dissolution provisions are not helpful, Delaware law provides dissolution procedures¹ but these also may not be helpful. Members of an L.L.C. should not take any comfort in the provisions

¹ 6 Del. C. § 18 - 801

of the Delaware Limited Liability Company Act as an exit mechanism. Section 18-1802 provides a possible exit mechanism,² but recent case law has shown that the Delaware courts are loath to dissolve a limited liability company simply because of changed circumstances, including bad economic conditions or a failure by the company to perform as anticipated.

Without some forethought and careful drafting of the operating agreement, a member wanting to withdraw or remove another member may find that neither the operating agreement nor the Delaware Limited Liability Company Act will provide meaningful options.

BUY-OUT/VALUATION

We have discussed “shotgun buy/sell” arrangements in a previous issue. A shotgun / buy-sell provision allows a member to initiate a buyout process by offering to either buy the other member’s interest at a specified price or sell its own interest using the same pricing methodology. Generally, the other member has the option to either (i) accept the offer and sell their interest at the proposed price or (ii) decline the offer and become the buyer at that price. While clients generally like this type of provision as it incentivizes members to carefully consider the valuation of the company, and can provide a swift resolution to disputes over ownership interests within the L.L.C., such a provision generally favors the party with the deepest pockets and the result can be inequitable.

In the hypothetical fact scenario mentioned above with two members, the member with the production capability would potentially have to overpay to take out the other member. At the same time, the member with the sales knowledge and contacts that didn’t eventuate would not be in a position to put any value on the company as without the production partner, the sales business would have little value.

Often, the splitting of partnership interests is much easier and less expensive if the L.L.C. Agreement sets out a structured roadmap for valuing the company and methodology and timeframe for one partner buying out the other. A carefully drafted agreement can match an exit mechanism with an exit trigger which will not only incentivize the members to maximize value but will provide for an orderly exit when the trigger is activated.

FUTURE OBLIGATIONS

Ancillary agreements with landlords, banks and vendors should be carefully reviewed in connection with exiting a partnership. Apart from change in control restrictions and the implications of that on various contracts, the member exiting should ensure that he or she is no longer a guarantor on any of the L.L.C.’s obligations. It is common for a lease of premises to contain a personal rent guarantee from one or both partners. Leaving the partnership does not release the exiting partners from guarantee obligation, and the landlord’s consent would be needed for a lease amendment. While this is typically doable in conjunction with the global settlement,

² “On application by or for a member or manager the Court of Chancery may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement.”

it can be time consuming, and the landlord should be informed in the early stages of the discussions around breaking up the partnership. Members of a troubled L.L.C. often are loath to reach out to the landlord, for fear of triggering adverse responses by the landlord.

FURTHER ASSURANCES

The partners should agree to execute any further required documents to finalize the breakup and the exiting partner should see an amended and restated operating agreement evidencing the new ownership together with a general release from the remaining partners, releasing the departing member of the L.L.C. from all future obligations and liabilities of the company.

CONCLUSION

Breaking up a business partnership can be difficult and emotional. Often these closely held partnerships are between friends or individuals who have worked together previously. When trouble arises, conversations become difficult, but partners should be prepared to discuss ongoing issues and should set time on a regular basis to talk about how the partnership is doing in terms of where they are and where they want to be. The problems that lead to the desire to close a business rarely occur overnight. It is important that partners have frequent conversations so that they are able to spot the early signs of a failing business and either work out a plan to fix the problems or amicably agree to go their separate ways before the relationships sours to a point where any agreement becomes difficult.

