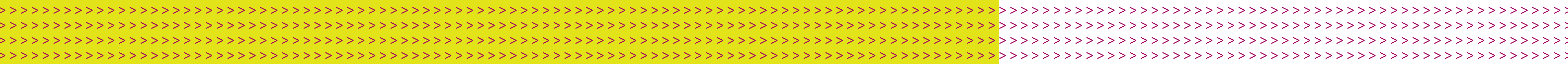

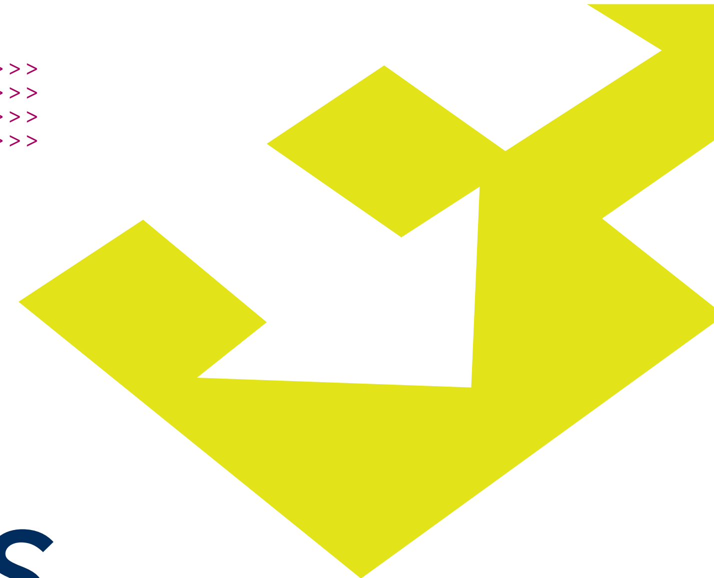

JOINT VENTURES

EXITS AND TERMINATIONS

Over time, parties to a joint venture arrangement may find that their vision or strategic interests have diverged. In these cases, well-crafted exit and termination provisions may help parties retain as much value from the joint venture as possible. This article explains why exit and termination provisions are useful and explores the primary issues to consider when drafting and negotiating these provisions.

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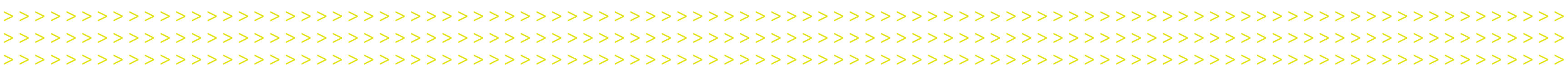
Joint ventures are designed to be flexible business organizations that can dynamically respond to market conditions and other changing circumstances. However, as time passes and circumstances change, parties to a joint venture arrangement may no longer share the same vision or strategic interests; one party may have difficulty performing its responsibilities due to financial or other operational difficulties or one of the parties may undergo a change of control or default under the joint venture agreement. In these cases, well-crafted exit and termination provisions may be the best way to retain as much value from the joint venture as possible.

There are numerous ways joint venture parties (JV parties) can provide for an early exit from, or termination of, a joint venture. An overview of the common themes can provide a good foundation for deal-specific, creative solutions.



This article explains:

- The benefits of contemplating at the outset what should happen if circumstances change significantly for the JV parties.
- Common types of exit and termination provisions and key considerations for drafting and negotiating those provisions.

For purposes of this article, a joint venture is an entity created by two or more parties to pursue a specific business, where each party is contributing key assets or capabilities to the pursuit of the joint enterprise. Parties typically use either a limited liability company (LLC) or a corporation as their joint venture entity. The governance flexibility and tax attributes of an LLC make it the more popular choice.

>> For more information on joint ventures, search Joint Ventures: Overview and Forming a Joint Venture Checklist on our website.

WHY HAVE EXIT AND TERMINATION PROVISIONS?

There are two main reasons why JV parties need exit and termination provisions:

- Deadlock.
- The default or change of control of one of the parties.

THE DEADLOCK PROBLEM

Many joint ventures have only two or three parties. A typical joint venture structure may have two corporate parents each owning, either directly or indirectly, a substantial equity interest in the corporation or LLC that serves as the joint venture entity. Each party may contribute certain key officers to the joint venture and these officers will have the authority to make day-to-day operating decisions within the scope of their duties.

Most often, however, a number of significant decisions require each of the parties, through their representatives on the applicable governing board of the entity, to agree in order to implement specified fundamental actions, such as:

- Approval of annual budgets and business plans.
- Raising additional equity capital from the existing parties or others.
- Amendments to the joint venture entity's governing documents.
- Engaging in a public offering.
- Mergers, acquisitions and dispositions of all or substantially all of the joint venture's assets.
- Dissolution or voluntary insolvency filings.
- Incurring debt above a pre-existing limit.
- Granting liens on material assets, subject to pre-defined exceptions.
- Entering into or modifying agreements with affiliated entities.
- Creating new subsidiaries or making material investments in third parties.
- Granting exclusive licenses under the joint venture's intellectual property rights.

This list can be expanded and often is.

Even if only a limited number of these actions requiring a supermajority are adopted, disagreements on strategy can materially disrupt the operations of the joint venture. This results in a deadlock in the management of the joint venture. A deadlock is typically defined as the inability of the JV parties to agree to any one of a particular subset of these supermajority issues.

From a practical perspective, the JV parties normally realize a deadlock is not in either party's interest. The business is left rudderless, which hurts its value. This is a lose-lose situation. The parties will want to negotiate a solution. Well-crafted exit and termination provisions can provide a starting point from which the parties can negotiate a solution that they might not otherwise be able to reach in the absence of these provisions.

DEFAULT AND CHANGE IN CONTROL

In addition to deadlock situations, if one party materially breaches the joint venture agreement, the other party will usually be entitled to trigger exit provisions. For example, in a situation where the parties previously have agreed to make certain capital contributions, but later one party is unable or unwilling to do so, the other party may no longer wish to continue working with the defaulting party.

The terms of the exit in a default or change of control usually vary from the deadlock situation because one party is at fault. In the case of a default, the non-defaulting party can decide whether to buy out the other party or sell its own interests under a buy-sell provision. Alternatively, the non-defaulting party may decide to invoke dissolution of the joint venture (see below *Documenting the Exit or Termination*).

A change of control of one party is often treated similarly to a default. The identity of the joint venture partner is often important enough to trigger exit rights in favor of the party not experiencing the change in control. A party may be reluctant to agree to creating these optional rights for any change in control. It might argue that creating these rights in favor of its joint venture partner in response to any change in control is a windfall when the identity of the new controlling party is no threat to the joint venture.

This provision is often the subject of detailed negotiations that might limit exit rights to situations where the acquiring party is a member of a specific group of competitors or is an entity engaged in a certain category of business activities.

COMMON ARGUMENTS AGAINST EXIT AND TERMINATION PROVISIONS

Although there are many arguments for including exit or termination provisions, some JV parties decide to remain silent about this in the joint venture agreement.

Common arguments against including exit or termination provisions include:

- They make it too easy to abandon the joint venture.
- They are too hard to negotiate and are unlikely to be used.
- They cannot be properly drafted at the outset to cover issues emerging later.
- One party may manipulate the provisions to take advantage of a weakness in the other. For example, if one JV party is much smaller and has less capital available than the other, the stronger party could cause a deadlock to occur in hopes of triggering a buy-sell provision where it can buy out the other JV party at a price below what the other would voluntarily accept.

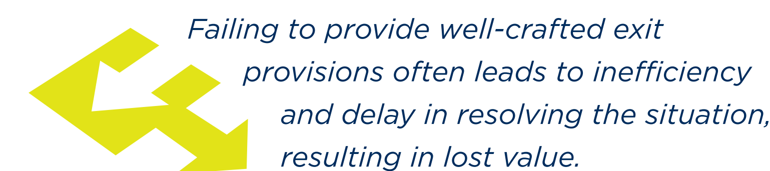
Although these are legitimate concerns, thoughtful exit provisions customized to the specific facts of the proposed joint venture can address them. The provisions can:

- Reduce uncertainty and create a level playing field.
- Allow the parties to implement rules for ending their relationship designed to maximize the value of the joint venture.

Even if the mechanisms envisioned by the provisions are not used (which often turns out to be the case), this does not mean the provisions are not valuable or important. The fact that the provisions are present and can be invoked is often enough to cause parties to work through key issues, such as valuation, that otherwise might have mired them in inaction.

WHAT IF PARTIES DO NOT PROVIDE FOR AN EXIT?

Failing to provide well-crafted exit provisions often leads to inefficiency and delay in resolving the situation, resulting in lost value. However, if the parties do not provide for mechanisms to deal with a deadlock, applicable law can be used to address the situation.



Failing to provide well-crafted exit provisions often leads to inefficiency and delay in resolving the situation, resulting in lost value.

For example, the Delaware General Corporation Law (DGCL) provides that the Delaware Court of Chancery may appoint a custodian when, for example, the "business of the corporation is suffering or is threatened with irreparable injury because the directors are so divided respecting the management of the affairs of the corporation that the required vote for action by the board of directors cannot be obtained and the stockholders are unable to terminate this division" (*DGCL § 226*).

In the case of a Delaware LLC, the Delaware Limited Liability Company Act (DLLCA) provides that "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" (*DLLCA § 18-802*).

However, a court-appointed custodian or court-ordered dissolution can lead to a protracted dispute and loss of value of the joint venture.

A 2009 Court of Chancery case illustrates what can happen when there are no express exit provisions. In *Fisk Ventures, LLC v. Segal*, Fisk Ventures' operating agreement called for a board of five managers to manage its affairs, but with many actions subject to the approval of 75% of its members. The court noted that the history of the company showed it suffered from a state of virtually perpetual deadlock. The lack of good exit provisions appears to have contributed to over five years of discord before one of the members finally sought judicial dissolution. In its decision, the court highlighted the compelling argument for including express exit provisions, stating that, "This case involves a long-lived corporate dispute that resulted in devastating deadlock to [the company's] Board and the loss of significant value to all involved. [The company's] Board is hopelessly deadlocked, and the LLC Agreement fails to anticipate that risk by prescribing a solution to the Board conflict" (*Fisk Ventures, LLC v. Segal, 2009 WL 73957 at *16 (Del. Ch. Jan. 13, 2009)*).

DRAFTING AND NEGOTIATING EXIT AND TERMINATION PROVISIONS

KEY EXIT AND TERMINATION PLANNING ISSUES

When contemplating exit or termination provisions in a joint venture agreement, preliminary questions to consider include:

- Under what circumstances may a party trigger a buy-sell mechanism or dissolution?
- Who is entitled to commence the exit procedures? What are the mechanics to do so?
- What are the consequences of each of the following scenarios on the full array of other joint venture relationships?
  - Consummation of a buy-out following deadlock.
  - Commencement of dissolution following deadlock.
  - Consummation of a buy-out following default or change in control.
  - Commencement of dissolution following default or change in control.

In addition to the procedures and financial terms embedded within the exit and termination provisions, the parties will also need to contemplate the impact of these actions on other issues:

- What happens to employees that may have been contributed or seconded by the exiting party?
- What intellectual property licenses survive (considering both in-bound to, and outbound from, the joint venture)?
- Is it appropriate to make any modifications regarding exclusivity, royalties and field of use provisions that should be automatically triggered on the exit or termination (known as springing modifications)?
- Are there other critical assets or regulatory licenses that require special treatment?
- Will non-competition agreements survive? For how long?
- What happens to distribution and supply arrangements among the parties and their affiliates?
- How will regulatory requirements affect the contemplated exit provisions (for example, the need to comply with Federal Communications Commission, Hart-Scott-Rodino, and foreign investment, ownership and control regulations)?

DOCUMENTING THE EXIT OR TERMINATION

The most common forms of joint venture entities used are LLCs and corporations. In the case of an LLC, the LLC agreement (also referred to as the operating agreement) usually contains the provisions relating to governance of the company, along with the exit and termination provisions. In the case of a corporate joint venture, some governance provisions are in the by-laws and certificate of incorporation, but there is also usually a stockholders agreement containing additional governance provisions, along with the exit and termination provisions.

>> For a sample long-form stockholders agreement, including explanations and drafting and negotiating tips, search Stockholders Agreement (Two-party) on our website.

The most common forms of exit and termination provisions are:

- Escalation and mediation.
- Buy-sell.
- Mandatory dissolution.

Escalation and Mediation Provisions

When a deadlock arises in a joint venture, the first step to try to resolve it is often an escalation procedure. An escalation provision applies when the issue has already been discussed by the board of directors (in the case of corporations) or the board of managers (in the case of LLCs) but has not been resolved. A party that wishes to break the deadlock must provide notice to the other party and then the issue is submitted to specified high-level officers of each JV party. Those officers will then be required to attempt to resolve the deadlock for a specified period of time.

In some cases, mediation might be used to aid this attempt at dispute resolution. In other cases, the non-binding mediation is replaced by allowing the mediator to act as an independent expert who resolves the dispute in a binding manner with their own decision or by acting as a neutral tie-breaker and siding with one party or the other.

>> For sample deadlock provisions, search Stockholders Agreement: Deadlock (with Mediation) and LLC Agreement: Deadlock (with Mediation) on our website.

However, this binding approach is somewhat rare and can be problematic because using an independent expert is better suited to resolving factual matters than making complex business judgments. For example, imagine a joint venture governing body that is deadlocked over whether to admit a new strategic partner to the

BUY-SELL MECHANISMS

BUY-SELL APPROACH 1

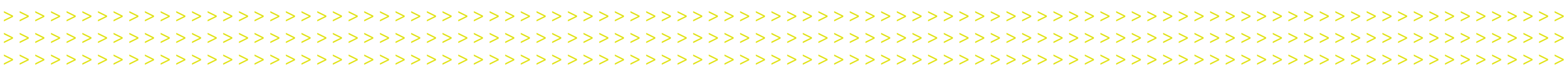
- One party notifies the other that it is making an offer to **either** buy or sell its stake in the joint venture based on a stated price per percent of equity ownership.
- The receiving party decides whether to be the buyer or the seller using the stated price.
- The buyer resulting from this process pays all cash at closing.
- The seller makes representations contained in the provision regarding ownership of the equity sold and the absence of liens or other encumbrances on such equity.
- If the buyer defaults on the purchase, the seller has the option to pursue remedies or become the purchaser at a discount (such as 90% of the defaulting buyer's price).

This approach is often resisted in cases where there is a significant disparity in the financial resources of the two parties. The party with fewer resources often worries that the other party will know it cannot be the buyer at a certain price and will take advantage of this knowledge. However, this is a risky path for the larger party, especially if the provision builds in enough time for the other party to find financial partners.

BUY-SELL APPROACH 2

- One party notifies the other that it is commencing an appraisal process.
- The appraisal method chosen sets a floor price per percentage interest in the joint venture.
- Both parties submit a notice stating whether they wish to be the buyer or the seller at the determined price.
- If one party wishes to sell and the other wishes to buy, the parties proceed to closing.
- If both parties wish to buy at the determined price, an auction process is commenced, often with minimum incremental increases required to top the other party's bid. The party that is willing to pay the most for the joint venture ends up as the buyer.
- If both parties wish to sell, they need to continue to work out the dispute. The rationale is that if neither party is willing to pay the determined price to break the deadlock, the deadlock is likely not yet a material threat to the health of the joint venture. However, this approach can be coupled with an additional clause that provides if the same deadlock is the subject of a second dispute within 12 months, and both parties again wish to sell, the parties will be required to sell the business in a manner designed to maximize the proceeds.
- If the buyer defaults on the purchase, the seller has the option to pursue remedies or become the purchaser at a discount (such as 90% of the defaulting buyer's price).

This second approach may be preferred even when there is not a disparity in the financial resources of the party since it has the benefit of setting a floor price in a fair manner and allowing more deliberation.



joint venture or whether to raise additional equity funds under a new series of preferred equity with terms on which the parties cannot agree. These are not the types of decisions for an outside expert, even if the expert is a business executive with excellent industry experience.

Key issues to consider when drafting and negotiating escalation and mediation provisions include:

- What types of deadlock issues should be subject to escalation?
- To whom will matters be escalated?
- How long a time should be required to allow escalation to potentially resolve the dispute before moving on to the next option to break the deadlock?
- What types of deadlock disputes are appropriate for mediation?
- If mediation is chosen, should there be a single mediator or a panel?
- What type of credentials should the mediator have? Should it vary depending on the specific issue?

Buy-sell Provisions

A buy-sell provision is often used in connection with a deadlock. It is also often used, with certain modifications, if the other party materially breaches a joint venture agreement or experiences a change in control. A buy-sell provision is intended to result in one JV party buying the other out. Therefore, when the buy-sell provision is invoked, it ends the deadlock by removing a party from ownership in the joint venture.

In non-default situations, the buy-sell provision can be invoked by either party, usually after an attempt at resolution through escalation to senior executives of the JV parties has proved unsuccessful. Many times, the buy-sell provision cannot be invoked during an initial specified period of time, such as the first two years of the life of the joint venture. The rationale is that the parties should have some minimum level of commitment to the joint venture before an exit procedure is permitted. The initial business plans and budgets should be adequate to allow the parties to work through any disagreements during this initial phase of the life of the joint venture.

In a default situation, the non-defaulting party may invoke the buy-sell provision after any applicable cure period passes and the default has not been remedied.

Key issues to consider when drafting and negotiating buy-sell provisions include:

- Who will buy and who will sell?
- How will the purchase price be determined?
- When will payment be required?
- What happens to each of the other material agreements among the JV parties and affiliates, such as:
  - intellectual property licenses;
  - supply agreements;
  - distribution agreements;
  - credit agreements; and
  - credit enhancement arrangements.

The joint venture drafting process allows for a great deal of creativity, so there are numerous variations of buy-sell mechanisms. For two common approaches to address deadlocks, see *Box, Buy-sell Mechanisms*.

Some of the buy-sell mechanics can also be used when a JV party is in default. In this case, the non-defaulting party can typically decide, at its option, whether to be the buyer or the seller. The price will need to be set by an appraisal mechanism. If the non-defaulting party elects to buy, the agreement can provide additional concessions to the buyer, such as allowing the buyer to pay over a period of years with a promissory note. In this situation, agreements sometimes also provide an option for a bargain purchase by the buyer. However, a bargain purchase in this situation may not be enforceable and there is a risk that it could be interpreted as liquidated damages and an election of remedies. For example, the ability to buy out the defaulting JV party at 70 or 80 cents to the dollar of appraised value could be viewed as the equivalent of financial compensation for the breach (in other words, the defaulting party has "paid" damages by surrendering an asset worth, for example, $10 million for $8 million).

One cannot predict damages based on a default occurring in the future. Accordingly, the ability to choose to buy, at fair market value (rather than at a discount to the appraised fair market value), with a note payable over several years, while retaining all rights to remedies for the underlying default, is likely preferable to speculating that the discount is substantially equivalent to the damages arising from the applicable default.

Mandatory Dissolution Provisions

Joint venture agreements often have mandatory dissolution provisions. A mandatory dissolution provision is sometimes used instead of the buy-sell approach. Parties may believe that if a deadlock exists, rather than going through a buy-sell procedure, the business should be sold, either as a going concern or otherwise, with the individuals managing the dissolution tasked with maximizing the proceeds. The JV parties are typically permitted to participate as potential purchasers, along with third parties.

More often, the mandatory dissolution procedures can be used as a second option to the buy-sell provision. In a deadlock situation, it can also be a useful backup if the buy-sell procedure does not result in either party buying the other out, but the deadlock continues as a threat to the prospects of the joint venture. Alternatively, if a partner of the joint venture is in default, the non-defaulting party may prefer dissolution and want the right to exercise that option in the first instance.

Key issues to consider when drafting and negotiating mandatory dissolution provisions include:

- Who controls the process?
- What standards should apply to the controlling party's conduct? For example, should the controlling party have to use commercially reasonable efforts to maximize the sales price? How widely does the business need to be marketed and for how long?
- How should the process differ if it is invoked as a result of a party's default? For example, the non-defaulting party should probably be given control of the dissolution process, but subject to some protections against abuse by such controlling party.
- Are there any circumstances under which the JV parties should not be allowed to participate as potential purchasers?
- Should an auction process be defined in advance?
- If there are ongoing disputes, should the dissolution proceeds be paid into escrow pending the resolution of the disputes?
- What happens to each of the other material agreements among the JV parties and affiliates, such as intellectual property licenses, supply agreements, distribution agreements, credit agreements and credit enhancement arrangements?

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Due Diligence Considerations in Joint Ventures or 3-501-0083

Choice of Entity: Tax Issues or 1-382-9949

Mandatory Dissolution Mechanics

Mandatory dissolution provisions are highly fact-specific and must be well-integrated with the other features of the agreement, especially any buy-sell, default, and remedial clauses. They must also work properly with ancillary agreements, such as intellectual property licenses.

The following is an example of how a mandatory dissolution provision could be structured:

- After a default and the applicable cure period, the non-defaulting party may cause the dissolution of the entity. The non-defaulting party would oversee and control the dissolution procedures.
- In a deadlock situation, following the inability to resolve the deadlock through any other alternative provided in the agreement, either party may cause the dissolution of the entity. Either a specified officer or a specified committee of individuals may be required to manage the dissolution.

In either case, those managing the dissolution would be subject to a duty to act reasonably promptly and with a view to maximizing the proceeds of the disposition of the entity's assets. Additional provisions could also be included, such as requiring the retention of an investment banker that would engage in an auction of the business and make recommendations as to which bid is superior. The parties would be required to pay any amounts owed by them to the entity. The proceeds of the disposition of the entity's assets would be applied to:

- Reimburse costs of the dissolution process.
- Pay third party creditors.
- Pay debts owed to the parties.
- Distribute the remaining proceeds in accordance with the parties' equity percentages or capital accounts, as applicable.

The party, officer or committee managing the dissolution would prepare and deliver to the parties a statement with a final accounting.