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.
Practical Law The Journal

Practical Law The Journal

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 resolve 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.

DEFRACT 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 or change of control 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 provisions to take advantage of a party’s 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 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 the disadvantage of a weaker party 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.

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 § 236).

In the case of a Delaware LLC, the Delaware Limited Liability Company Act (LLSCA) 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” (DLCCA § 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 a 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 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.

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.
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 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.

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 joint venture.

The rationale is that if neither party is willing to accept the mediator's decision, the dispute will 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 proceed to close, the additional clause that provides if the same deadlock is the subject of a second dispute within 12 months, and both parties proceed to close, the mediator's decision will be binding.

**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.
- The seller from the sale resulting from this process pays all cash at closing.
- 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 realized 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 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 proceed to close, 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 can 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.

**DOCUMENTATION OF THE EXIT OR TERMINATION**

The most common forms of joint venture entities 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, and there is also usually a shareholders' agreement containing additional governance provisions, along with the exit and termination provisions.

For sample deadlock provisions, search shareholders agreement deadlock with mediation and LLC agreement deadlock provisions on our website.
Practical Law The Journal

When will payment be required?

- What type of credentials should
- How will the purchase price be
- Pay debts owed to the parties.
- - distribution agreements;
- Pay third party creditors.
- -

To whom will matters be escalated?

After a default and the applicable

What happens to each of the other

Should an auction process be defined

Distribute the remaining proceeds in

Key issues to consider when drafting

Buy-sell Provisions

A buy-sell provision is often used in

- What types of credentials should
- If mediation is chosen, should there be a single mediator or a panel?

- What type of credentials should the mediator have? Should it vary

Buy-sell Provisions

The joint venture drafting process allows

Key issues to consider when drafting and

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

Mandatory Dissolution Provisions

Joint venture agreements often have man-
datory 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 maxi-
mizing the proceeds. The JV parties are typi-
cally given the first right to buy, with the
remaining proceeds being distributed to
the parties.

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
provisions 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 dis-
solution would be subject to a duty to
act reasonably promptly and with a view
to maximizing the proceeds of the dis-
position 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 recom-
mandations as to which bid is superior.
The parties would be required to pay
any amounts owed to them by 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 specified capital accounts,
as applicable.

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

Joint Ventures: Overview or 0-380-9579
Competitor Collaborations in the US or 0-202-2806
Cross-border Joint Ventures or 7-100-2815
Due Diligence Considerations in Joint Ventures or 3-501-0083
Choice of Entity: Tax Issues or 1-382-9949

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
provisions 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 dis-
solution would be subject to a duty to
act reasonably promptly and with a view
to maximizing the proceeds of the dis-
position 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 recom-
mandations as to which bid is superior.
The parties would be required to pay
any amounts owed to them by 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 specified capital accounts,
as applicable.

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

Joint Ventures: Overview or 0-380-9579
Competitor Collaborations in the US or 0-202-2806
Cross-border Joint Ventures or 7-100-2815
Due Diligence Considerations in Joint Ventures or 3-501-0083
Choice of Entity: Tax Issues or 1-382-9949