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Recent Trends in Joint Venture Exit and Termination Provisions

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Where tax and other considerations make it possible, we find many of our clients use the joint venture structure because it provides tremendous flexibility to the joint venture partners in structuring their relations and determining how the joint venture will operate. Most savvy joint venture partners also enjoy the flexibility the joint venture structure allows in deciding when and how partners can unwind or exit the venture. The exit and termination provisions of a joint venture are almost always a key issue in negotiations in forming a joint venture, and the joint venture structure allows the parties to tailor creative solutions to meet the specific business goals and needs of the joint venture partners and the joint venture itself. This alert explores common concepts that joint venture partners consider when negotiating provisions related to when they can (or must) exit an investment.

Going in with an Exit Plan

Many joint ventures are formed by partners who want to create value by combining different types of assets, including any combination of cash, financing commitments, tangible assets, and intangible assets such as human talent, intellectual property and contractual rights. The terms of a joint venture will impose specific controls on a partner's ability to exit the venture, particularly where the partners are contributing non-fungible assets, the business is integral to the development of the partners' other businesses, or where the partners are themselves unique or irreplaceable. Such controls permit partners to protect not just their investment, but also protect the assets contributed by partners to the joint venture and the manner in which those assets are exploited.

Exit provisions will generally seek to accomplish one or more of the following objectives:

- permit liquidity;
- anticipate and avoid deadlocks among the partners; and
- deter and punish breaches of the governing agreements.

Well-constructed exit provisions will enable the partners to:

- avoid triggers that could require the business to be valued prematurely, before its full value can be realized;
- avoid triggers that could disrupt or damage a business, or encourage gamesmanship;
- match the appropriate exit right (e.g., permitted transfer, initiation of a buy/sell process, or ability to force a sale) with the triggering event; and
- effect an outcome that is cost-effective, maximizes enterprise value, and distributes value equitably.

Exit Triggers

There are three common types of triggers that either permit or require one or more partners to exit the joint venture, each of which is discussed briefly below.

Opportunity to Monetize or Change in Circumstances. Where partners are restricted from transferring their interests in a joint venture vehicle or arrangement, the most common exception to the transfer restrictions is an agreement that after a period of time, or after the occurrence of some no-fault event, one or more partners are entitled to transfer their interests to a third party. Permitting transfers after a minimum period of time ensures that partners are not locked indefinitely into an investment. Other common exceptions allow transfers after the occurrence of certain events that diminish the contributions of a particular member, or either affect or could affect the basis on which a partner has contributed to a joint venture. For example, exit rights may be triggered upon a change in the business of the joint venture, or a change in one of the other partners (e.g., if after a change of control, the partner is controlled by a competitor or another person whose ownership of the joint venture interest would raise issues (regulatory or otherwise) for the other partners or for the joint venture).

Where, as a result of the passage of time or the occurrence of an event, one or more partners have the ability, or are required, to exit the venture by transferring their interests, joint venture agreements commonly provide certain protections for the non-exiting partners. The most common protections are rights giving the non-exiting partners the first opportunity to acquire the exiting partner's interests or tag-along rights. Preferential rights to buy (or try to buy) the exiting partner's interests can range from a fairly soft right of first negotiation or offer to a right of first and last refusal (i.e., the ability to acquire preemptively or by matching any other offer). The parties may also agree that the venture itself has an initial right to repurchase the exiting partner's interests, and the non-exiting partners may only purchase the exiting partner's interests if the venture declines to do so. Tag-along rights assure that all partners have the right to exit on the same terms and conditions. They may come into play even if the non-exiting partners have a right to acquire the exiting partner's interest (although non-exiting partners are usually prohibited from seeking to exercise rights to acquire and rights to tag-along with respect to the same transfer). Other types of protective provisions may require that the transferee meet specified criteria, such as net worth

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requirements or experience in the venture's industry.

In some instances, however, a partner may negotiate the right (after a period of time, or upon the achievement of some milestone) to force a sale of the entire venture by initiating a sale or finding a buyer and exercising drag along rights, or the ability to obtain liquidity by compelling an initial public offering of the venture (generally through a corporate successor entity, if the venture vehicle is not a corporation). In such cases, the other partners will generally seek control of or meaningful input in such process, as well as protection from disparate treatment, to ensure that all partners receive the same amount and form of consideration and are obligated to give comparable representations, covenants and indemnities in connection with the transaction.

Inability to Operate. Many state laws related to forms of entities often used as joint venture vehicles provide a mechanism that can be invoked to dissolve and windup the business of a joint venture if the partners are unable to carry on the business (see, e.g., Del. Limited Liability Company Act Sec. 18-802 and Sec. 18-803). But joint venture partners frequently waive such provisions and substitute their own criteria for determining when a joint venture no longer has the ability to function and the consequences of that dysfunction. Partners may want to ensure that they have the ability to take action before the joint venture's operations and financial condition have been so severely impacted that recovery is uncertain, and therefore specify triggers that would be tripped earlier than the point at which state statutes would permit an involuntary dissolution.

The exact parameters of or events giving rise to such an "inability to operate" trigger should always take into account the specific facts and circumstances applicable to the joint venture. In addition, the consequences of those parameters or events frequently vary. In some scenarios, such as when the business has failed and there is no reasonable path to obtain additional financing, the partners may provide that any partner can initiate a sale of the business in which all the partners can bid. If no partner or third party offers to buy the business, a dissolution proceeding would be deemed authorized. Conversely, where the inability to operate results from a deadlock of the governing body, but some value remains in the business, the joint venture agreement should provide a relatively quick and finite process for resolving the deadlock. Frequently the process negotiated will include a right to buy or sell interests among the partners until one partner has an interest that permits the deadlock to be broken. In these situations, however, joint venture agreements must provide mechanisms for ensuring that a partner cannot create – and then benefit from – a deadlock to the detriment of the other partners.

Finally, joint venture agreements must dictate how the business will be run while a deadlock is resolved. Ideally, the venture agreement should include provisions related to a default business plan and budget that, at a minimum, will ensure the venture can operate while the partners work through the deadlock period and exit mechanics.

Defaults. The ability to force a partner to sell its interests due to a default is still fairly unusual. Where there is such a provision, it tends to relate solely to actions (or failures to act) which are relatively objective and where it is easy to determine if they have occurred (or failed to occur). Failure to contribute capital in accordance with a valid capital call is perhaps the easiest type of default to establish as a trigger to a forced sale. Violation of certain provisions of the joint venture agreement may be deemed a material default that leads to a sale obligation. Common "material breach" triggers leading to a sale requirement include breaches of non-compete or non-solicit provisions and (particularly in joint ventures where intellectual property constitutes a significant asset of the joint venture) violations of confidentiality provisions or unpermitted uses of joint venture assets.

If a default provision requires the sale of the defaulting partner's interest, the purchase of the defaulting partner's interest should be an option, not a requirement, or the non-defaulting partners should have the ability to structure the purchase price and payments in a manner that will not unduly burden the joint venture or the non-defaulting partners. A provision that permits a partner intentionally to trigger a default and thereby create an exit may encourage actions that adversely affect the joint venture. In addition, if there is a default provision, the other consequences of a default should be expressly addressed. For example, if a partner is in default, whether that partner can or must participate if other exit provisions are triggered should be addressed (e.g., can a defaulting partner participate in a tag along sale, or exercise a right of first refusal on the purchase of another partner's interest during the period after default and before the defaulting partner exits).

In some instances, the default may have damaged the joint venture itself. For example, if a partner is prohibited from competing with the venture but violates that prohibition, the non-defaulting partners may prefer to exit the partnership rather than retain their interests and force a sale by the defaulting partner. Anticipating such circumstances, the venture agreement may state that upon a default, the non-defaulting partners may force the defaulting member to purchase the interests held by the non-defaulting partners. In such a scenario, however, consideration must be given to whether this is a realistic remedy – is the defaulting partner likely to have the assets to satisfy the requirements?

Finally, thought should be given as to whether the exercise of any of the foregoing rights by the non-defaulting partners should be their sole and exclusive remedy, or if they should retain any additional rights (including, for example, in the cases of fraud or willful misconduct by the defaulting partner).

Valuation Related Issues on Exit

Whenever a joint venture agreement provides that a partner may be forced out, or where non-exiting partners have a right to purchase or sell at a price other than one set by a third party (e.g., in a situation where the non-exiting partners are not exercising rights to match a third-party offer) the negotiations related to provisions on how to price the exiting partner's interest tend to be lengthy and complex. The issue of valuation and valuation techniques in exit situations is a topic that deserves its own summary, and we do not cover it here. But there are a number of related issues that joint venture partners should consider in negotiating exit provisions.

First is the valuation process itself. Whatever process is used to determine value, the partners should discuss and agree in advance on one that will not harm the value of the joint venture. There should be clear agreement, for example, that information used for the valuation

process, as well as the valuation itself, is confidential information and may not be used by any of the joint venture partners (or former partners) for any other purpose. The process should not be so onerous or lengthy that it affects the ability of the joint venture to operate in the ordinary course.

Second is the coordination of the various parties in the event that there are multiple defaulting and/or non-defaulting partners. In such cases, careful consideration should be given to who governs the process, and to what extent any partner may commit other partners to a particular course of action. For example, if a partner determines that the venture should purchase the interests of a defaulting partner, may the venture make a capital call from all its non-defaulting partners or incur debt to fund such purchase?

Lastly, particularly in a situation where a non-exiting partner may be able to quickly flip its interest (e.g., where the non-exiting partner would be able to sell control as the result of acquiring the exiting partner's interest), joint venture agreements may include a "share the wealth" provision. That type of provision requires the non-exiting partner to provide the exiting partner with a pro rata share of any positive differential in value that the non-exiting partner achieves in the subsequent sale of its interest in the joint venture. Note that share the wealth provisions tend to be applicable only for a very short period of time after the exit, or require a valuation significantly higher than that paid to the departed partner, to avoid sharing an increase that merely reflects ordinary course improvements in the business of the joint venture.

Summary

Joint venture partners have learned that it pays to consider what events or circumstances should trigger a mandatory or optional exit from a joint venture, and are taking advantage of the flexibility of the joint venture structure to create more discipline and certainty around such events. New ideas tend to be driven by the unique characteristics and goals of the joint venture and its partners, and continue to evolve as joint venture partners and their lawyers learn from experience, so a careful review of the most recent joint venture precedents is a key step in any negotiation of exit provisions.



Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you work, any of the following, or any member of the firm's Corporate Transactions Practice Group:

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