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How Easy Is Your Exit?

Opportunities and pitfalls of buy-sell mechanisms.

BY ANDREW H. LEVY AND JENNIFER L. ROHMANN

IT IS NOW commonplace for partnerships and limited liability companies to serve as the vehicles for the acquisition, development and management of real estate assets. Whichever form of entity is used, there is often an operating partner (the OP) and a capital partner (the CP). The OP provides the "sweat equity" and some capital, while the CP contributes most of the required capital (and some oversight of major decisions). In these ventures, the capital (to the extent contributed by the venturers) typically receives a preferred return, with increased returns for the OP (the "promote") only when the capital has received a minimum return.

Although the venturers[1] embark on this collaboration expecting harmony, they need to consider from the beginning how to end the venture if expectations are not met, whether because of operational deadlocks, disagreements over financing and/or changes in the market. Particularly now, with so much stress in the real estate and finance markets, venturers will be forced to address more so than ever how to unravel, modify or exit from existing ventures.

One way to provide for such an end is to include a "buy-sell" mechanism in the limited liability company or limited partnership agreement.[2] The buy-sell essentially allows one of the venturers (the "triggering venturer") to force the other venturer (the "non-triggering venturer") to either buy the triggering venturer's interest in the venture, or sell its own interest to the triggering venturer. The balance of the mechanism is theoretically provided, typically, by the fact that one venturer selects the price, while the other decides to either buy or sell at that price.

The authors have dealt with many such circumstances, on behalf of both operating and capital partners.

The buy-sell option is not a perfect solution. Despite the fact that countless agreements include buy-sell mechanisms, exercise and completion are rare, which may reflect the fact that the major purpose of the buy-sell is to equip each of the venturers with a sword of Damocles with which to force consensual action as a better alternative.

Even if perfectly drafted, the buy-sell mechanism is expensive and time-consuming to implement, and can result in a situation where the initiation occurs at a bad time—and the culmination occurs at a time when circumstances have radically changed. The fact that one venturer would consider triggering the buy-sell indicates that the venturers cannot resolve their differences consensually, likely after already having expended significant time, energy and expense trying to do so.

The typical buy-sell provides for notice, election and closing periods, which can amount to months, even barring all possible delays in implementing the buy-sell. The triggering venturer will typically not know until the non-triggering venturer has made its election whether the triggering venturer will be buying or selling, which may present challenges and expense with respect to arranging any necessary acquisition financing. Each venturer will have unique tactical and strategic advantages and disadvantages, making the decision to buy or sell a difficult and stressful one. And a recalcitrant venturer who feels that the sword is being used unfairly is likely to litigate, introducing more uncertainty and delay into the process.

Despite its faults, the buy-sell option may still be the best of all available exits. In order to minimize some of the difficulties, however, the buy-sell should be drafted to provide a clear process and minimize any grounds for challenge. Additionally, the venturer considering whether to trigger the buy-sell or how to respond to its invocation should consider several issues.

Venturers can avoid many issues that may surface in triggering and/or responding to the buy-sell when drafting the venture's operative agreement. What follows is a brief discussion—but by no means an exhaustive list—of the types of questions and problems venturers may address at the negotiation and drafting stages. As a general rule, if a venturer expects specific treatment during or after, or a particular result from, the buy-sell process, the operative agreement should so state. Using a boilerplate provision, or creating uncertainty, is asking for trouble, usually in the form of litigation or delay, in the event that the mechanism is actually triggered.

Timing

The issue of timing involves consideration of both the stage of the dispute and the actual time for triggering the provision.

Some buy-sell mechanisms require a deadlock. But on what category of issues must the venturers be at total odds, and how will they determine that they have reached a deadlock? The longer the list, the easier it is to trigger the mechanism. Must one party notify the other of irreconcilable differences? May either party trigger the buy-sell at any point thereafter, or will there be a mandatory "good faith" negotiation period or cooling off period during which the parties will attempt to resolve their disagreements? Who will monitor

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the negotiations? The venturers may consider requiring the services of a third-party mediator. And, if there is a good-faith negotiation period, what is to prevent one of the venturers (either in good faith or otherwise) from asserting that the other has not used good faith, and thus the mechanism is not properly triggered? Even if there has been good-faith negotiation, is that step subject to summary judgment if the case goes to litigation? This one element could stall and even stifle the entire mechanism.

With regard to the time for triggering the provision, the venturers may want to allow triggering of the buy-sell at any time after the inception of the venture, or instead impose a lockout period or phase-based periods during which no venturer may exercise the buy-sell. This decision may depend largely on the venture's underlying projects, and the objectives and negotiating strengths of the respective venturers. If the venture's primary purpose is to acquire and manage a stable property, it may not matter as much when or if the buy-sell is triggered. But if the venture's main purpose is to develop property from raw land or convert rental property to condominiums, the overall success of the project may benefit from allowing the buy-sell to be triggered only outside of certain critical stages, and the tactical positions of the venturers, at different times, should be assessed.

Another timing point relates to the availability of other contractual exit options. For example, if sale to a third party exists as an exit, the venturers should provide that neither may use the buy-sell to preempt a third-party sale already in progress, and vice versa.

Whatever agreement the parties reach pertaining to timing, any prerequisites must be stated clearly and unambiguously, leaving no room for multiple interpretations or litigation.

Price

A buy-sell provision should set forth some manner of determining a purchase price, no matter which venturer becomes the buyer. One way of setting the price is to establish an aggregate net value for the venture's assets from which the price is derived by applying the operative agreement's distribution provisions. If the venturers adopt this approach, they should decide in advance who will determine that net value, and how. Will the triggering venturer establish the value? If so, will that venturer be obligated to "show its math"? Or will some independent, third-party mechanism be used, such as a third-party appraisal? Will apportionments or special adjustments be made, and/or will a "true-up" occur at or after closing? (A true-up is a process that would adjust a previously stated purchase price to account for actual, rather than estimated, expenses and other such items that may cause the price as previously stated to fail to reflect the appropriate value at closing.) Finally, what role, if any, will the venture's accountants, or some other party, play in establishing the value, applying any adjustments and/or running through the distribution provisions?

In addition to choosing a mechanism for setting a price, the venturers should give serious consideration to the date at which the price is set, and whether subsequent modifications to a stated price will be allowed in order to reflect interim changes in the venture's value. For instance, a buy-sell may provide that the price be established when the triggering venturer invokes the option. However, countless events may occur between triggering and closing that would render such price not reflective of either or both venturers' then-current views. Among other things, the venturers may contribute capital or receive distributions; if the project is financed, interest must be paid; in the case of ongoing projects, contractors, consultants, management personnel and so forth must be paid; and if the project is stalled because of discord between the venturers, the asset remains vulnerable to market dips, or even unexpected increases. May the price as initially stated be adjusted for these events?

In establishing a pricing mechanism, the issue of the promote will be particularly relevant to the OP in the event that it becomes the seller. What, if any, portion of its promote will the OP be entitled to receive, especially if the project has not yet matured in accordance with the original business plan? In development and/or opportunistic investments, the OP often insists on a lockout period for this reason. Perhaps the pricing mechanism will account for the OP's exit at an early stage of the venture, when the OP has not yet been able to reap any of the expected benefits of the promote structure, at least if it is the CP who triggers the buy-sell.

Management

In a typical real estate venture, the OP manages the daily affairs of the venture, often with the CP retaining approval rights for certain major decisions. In the context of the buy-sell, this dynamic may become the subject of litigation if not addressed adequately in the operative agreement.

The venturers should consider whether management will remain the same throughout the buy-sell process. If not, at what stage(s) of the buy-sell will the management mechanism change, and how so? For instance, will management control in the period between election and closing shift exclusively to the party that has elected to buy, or will the would-be seller retain some role? Which venturer can speak for and sign documents binding the venture during the buy-sell process? This is a question that is especially important with respect to actions needed to complete the transaction (such as the giving of a binding prepayment notice to the current lender, if the sale will involve a refinancing). Will the would-be seller, particularly if it has any management authority, have any obligation to cooperate in taking the actions or authorizing the documents needed in order to effectuate the transaction from the venture's perspective? If so, what will be the standard for judging whether that venturer is complying with its obligations?

The venturers should devote close attention to the interplay between the buy-sell and management provisions in the case of ongoing projects, such as developments and condominium conversions. Confusion regarding which party has management authority can derail and otherwise damage a project if plans and specifications cannot be finalized, contractors cannot be paid, project consultants and lenders do not know whose direction to follow, pricing for units cannot be determined or changed, designs cannot be made and so forth.

Default

Given the generally quick time frames and great degree of uncertainty involved in the buy-sell process, the venturers may wish to address in negotiations and drafting the possibility that the would-be buyer will fail to close or otherwise default. Is time of the essence? If time is not of the essence, then there will never be clarity with respect to the temporal elements! And, does the process come to an end if the would-be buyer fails to close within the time allowed, or will the would-be seller be given an election period and some form of adjustment for the would-be buyer's default?

Some of the more common such adjustments are the ability to purchase the defaulting venturer's interest at a discount and the option to take control of the venture.

If the non-defaulting venturer is to be offered a discount, the venturers should specify both the amount of the discount and the number to which the discount will apply. Will it apply only to the initially stated price, or also to the ultimate price as adjusted at or after closing? This point is particularly important in the case of active projects, in which the venture continues to require capital calls to cover expenses and capital costs. If the discount applies only to the initially stated price, then it will not affect interim capital contributions made by the defaulting venturer. However, if the discount applies to the price as adjusted to account for influxes of capital, then the defaulting venturer will suffer the effects of the discount even on capital contributions it made when it expected to own the asset.

The venturers may also include a change-in-management provision as a consequence of the would-be buyer's default. But how extreme will this change be? Will the non-defaulting venturer take complete control, the defaulting venturer no longer having any major decision approval rights? Or will the defaulting venturer retain some or all of these rights? Perhaps the list of major decisions subject to the defaulting venturer's approval will become shorter.

Another possibility the venturers may wish to consider in drafting is what happens if both venturers default. Suppose venturer A exercises an option to buy at a discount after venturer B has elected to buy and failed to close—and venturer A also fails to close. Has this particular exercise of the buy-sell finally reached its conclusion? If so, may the buy-sell be triggered again by either party?

When, and must all of the initial prerequisites be met anew? If the buy-sell is triggered again, do all of the same election and closing time periods apply? If management control has already shifted to venturer A upon venturer B's default, does it remain with venturer A, shift exclusively back to venturer B, or return to its pre-buy-sell state?

The venturers may also find it useful to think about whether and to what extent any venturer will be liable for damages resulting from its default. Must the venture ratify actions taken and documents signed during the buy-sell process, or will the would-be buyer assume responsibility for any defaulted third-party obligations in the event that it fails to close? For instance, if the would-be buyer has issued a binding prepayment notice to the venture's existing lender, and then fails to close because the refinancing fell through, or any other reason, the venture is left to pay off its existing lenders or else face foreclosure. Will the venture itself be responsible for any resulting losses (each venturer therefore suffering those losses on a pro rata basis), or may the non-defaulting venturer sue the defaulting venturer for damages for any resulting losses? Furthermore, may the would-be seller be subject to any legal action, including damages and/or preliminary injunctive relief, if it defaults in its obligation to close, including by delaying the closing in bad faith (or whatever standard the venturers may agree upon in the operative agreement)?

Other Issues

The following are several additional issues that the venturers should consider in drafting a buy-sell provision.

- Assignment of Venture Interest: What form will be used? Which covenants, representations and warranties will the seller make, and which, if any, will the buyer make? When will the assignment become effective? This may be a particularly complicated question if other project-related documents, such as financing documents, restrict transfers of interests in the venture.
- Release/Indemnification: What type of release from liability and/or indemnification will the seller receive, if any? Will the release and indemnification be in any way mutual? Especially if the seller is a general partner, should it be entitled to indemnification from the partnership and/or the buyer? What creditworthiness should stand behind any such indemnification, and what happens if that creditworthiness evaporates after the closing?
- Third-Party Obligations/Liabilities: What if the seller and/or any seller affiliate has made guarantees in favor of any lenders and/or other third parties? From which, if any, of these guarantees will the seller be released? What efforts must the buyer make to secure such release(s), and what is the consequence if the buyer is unable to procure such release(s)? Which documents, in addition to the operative agreement itself, create continuing obligations and liabilities from which the seller may desire to be released and/or indemnified? For instance, if the venture is engaging in a condominium conversion in New York state, and the Attorney General's Office has accepted an offering plan for filing, the seller's affiliate who was listed as a principal in the plan may want to be removed as a principal and indemnified for any claims arising in connection with the plan.
- Transfer Taxes: Which venturer will be responsible for payment of any transfer taxes due at closing?[3] Will the venturers split the cost on a pro rata basis or on some other basis by making the venture itself responsible for the taxes and reducing the purchase price accordingly, or will the seller be responsible for the entire cost?
- Tax Returns: How will the seller be allowed to participate, if at all, in preparing or agreeing to amend the venture's tax returns for any year in which the seller was still a partner, or in any audit process?
- Continuing Insurance Coverage: What rights, if any, will the seller have to remain a named or additional insured on the venture's insurance policies, or those of its contractors and/or subcontractors? How will the seller gain assurance of continuing coverage, and what enforcement mechanism will the seller have?
- Books and Records: If the seller is the OP, it will most likely be in possession of the venture's books and records. Which books and records must be turned over to the buyer? When and how must they be turned over? May the seller retain any copies?
- Hardware/Software/Furnishings: How and when, if at all, will software licenses be transferred to the buyer? What, if any, computer equipment and furnishings will the buyer be entitled to receive, and at what time?
- Resignations and Transfer of Shares: If the seller or any of its affiliates occupies any position of authority, such as serving on a venture affiliate's board of directors, what mechanism exists to force a resignation, and when will such resignation occur? Similarly, if the seller or any of its affiliates holds shares in any venture affiliate, what mechanism exists to force a transfer of such shares to the venture, the buyer or a buyer affiliate?
- Management and Other Fees: If either of the venturers or their affiliates is receiving fees, such as pursuant to a development or similar agreement with the venture or any of its affiliates, how will such fees be handled in the time between triggering and closing? Will any such agreement survive the closing, or must all such agreements be terminated and new agreements adopted? If the seller or its affiliates has been receiving fees from the venture, what other adjustments must be made to address the need to pay similar fees to some other party to provide the services for which the seller or its affiliates has been receiving fees?
- Employees: What will happen to the venture's employees? Will they continue to work for the venture? Will the seller or any of its affiliates be allowed to hire any of the venture's employees before or after closing? This issue becomes particularly difficult to address if the employees were originally the seller's employees or have particular loyalty to the seller.
- Restrictions: Must the seller and its affiliates refrain from engaging in similar projects or using any intellectual property from the current deal within a certain distance from the property and/or for a certain amount of time after the sale? What creditworthiness stands behind any such commitment?
- Confidentiality: What, if any, confidentiality restrictions will bind the venturers during and after the buy-sell process?

Conclusion

A buy-sell mechanism provides one way for an unhappy joint venturer to exit—however imperfect it may be. Many of the foregoing points may seem, to venturers just starting out, to be minor issues that can be resolved later if the situation arises. But once the disharmony between venturers has reached the level at which the buy-sell is seriously considered, it may be impossible for the venturers to agree on what color the sky is, never mind who gets to keep the computers. Thus, some extra time spent negotiating and drafting around certain issues in advance and giving due consideration to the tactical and strategic points involved in the buy-sell process may make for a smoother, cleaner exit if the buy-sell is actually triggered and completed.

1. Although a venture may consist of more than two venturers, this article assumes only two venturers, for simplicity's sake. If more than two venturers are involved, the issues discussed in this article become more complicated to address.
2. Other exit options include change of management provisions, third-party sale, long-term leasing, one-way put or call of a venture interest, mediation and/or arbitration, and judicial dissolution. This article addresses only the buy-sell option. For more information on exit strategies (and joint venture formation in general), see Joint Venture Task Force of the Negotiated Acquisitions Committee, Section of Business Law, American Bar Association, Model Joint Venture Agreement with Commentary 371-77 (2006) and Stephen I. Glover, "Drafting the Joint Venture Agreement," in 1 Partnerships, Joint Ventures & Strategic Alliances ch. 6, §§6.14, 6.17, 6.26 (Stephen I. Glover & Craig M. Wasserman eds., rev. ed. 2003).
3. Under New York city and state law, the sale of an interest in an entity owning real estate may be considered a sale of an interest in real estate, and transfer taxes can become due and payable. See New York Tax Law §§1401 ff (McKinney 2004 & Supp. 2008); New York City Charter & Administrative Code Annotated §§11-2101 ff (New York Legal Publishing Corp. 1996 & Supp. 2007).