

BUY/SELL PROVISIONS IN REAL ESTATE JOINT VENTURE AGREEMENTS

(with minor edits)

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Editors' Synopsis: This Article examines buy/sell provisions in real estate joint venture agreements. Beginning with a discussion of the purposes, problems, and alternatives to buy/sell agreements, the author provides a comprehensive discussion of how to structure buy/sell agreements. In the process, the author discusses the benefits and pitfalls of various buy/sell provisions, and the potential consequences of using them. A discussion of governing statutes is also included, with a review of certain Uniform Laws as well as Delaware statutes. The Article concludes with the warning that although a buy/sell provision is a common exit strategy in real estate joint venture agreements, it is a strategy that must be thoroughly understood and appropriately applied in order to be most effective.

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Attorneys frequently employ "buy/sell" provisions ("buy/sell") in real estate joint venture agreements to allow the joint venturers to part ways. Like any other exit strategy in which the venturers' interests are not aligned, a buy/sell is by no means perfect. This Article attempts to explain a buy/sell and to identify and address some of its imperfections. For simplicity, assume, unless otherwise stated, that the venture is a limited liability company ("LLC") or a partnership composed of two members or partners (venturers).

I. BACKGROUND: DEFINITION, PURPOSE, AND ALTERNATIVES

A. What is a Buy/Sell?

Unfortunately, practitioners may be confused about what a buy/sell is and what it should be called. The term "buy/sell" has multiple meanings, and to further complicate matters, other terms (e.g., "put/call" or "Texas draw") are sometimes used to describe the type of buy/sell that is the subject of this Article.¹ When used in this Article, "buy/sell" is intended to refer to a procedure under which one venturer eventually purchases the interest of the other venturer, but neither venturer knows at the outset who will be the buyer and who will be the seller. Under specified circumstances, a venturer may initiate this procedure, under which:

¹ See *infra* Part XII.

1. The initiating venturer must establish the prices of the venturers' interests, which will give both venturers consistent and relative values for their respective interests.
2. The other venturer then must choose whether to sell its interest under this pricing or buy the initiating venturer's interest under this pricing.

B. Why Include a Buy/Sell?

As one possible exit strategy for the joint venture, a buy/sell generally provides a mechanism under which the venturers may separate; one venturer acquires complete ownership of the venture and the other venturer liquidates its investment. Some practitioners also consider the buy/sell a useful means of dispute resolution, whether used to resolve the timing or manner of investment liquidation, or to deal with other major decisions that the venturers cannot otherwise resolve.

C. What About Other Exit Strategies?

The best joint venture exit generally occurs when the venturers are in agreement and their interests are aligned (when, among other matters, the venturers will not have significantly different tax consequences from the execution of the exit strategy). If both venturers want to liquidate their investment at the same time, then they simply can sell all the venture's assets. However, things are not always so simple. In addition to, or in lieu of, a buy/sell provision, many joint venture agreements provide for one or more other exit strategies, as discussed below, in case the joint venturers will not agree on when to sell.

1. Liquidation

Many venture agreements provide that the venture must be dissolved or liquidated at a certain point in time or upon the occurrence of certain events. Before the "check the box" regulations, venture agreements routinely provided for dissolution or liquidation to ensure that the venture was taxed as a partnership, but these provisions are no longer necessary for this purpose.² For non-tax reasons, many venturers continue to provide for dissolution and liquidation upon the occurrence of certain events. Statutes may even mandate liquidation.³ In any case, a liquidation can become a dis-

² See Treas. Reg. § 301.7701-3 (2004).

³ See, e.g., REVISED UNIF. P'SHIP ACT § 103(b)(8), 6 pt. 1 U.L.A. 74 (2001) [hereinafter "RUPA"].

tressed sale that yields less money to each of the venturers than would a consensual sale. Maximizing value is difficult when venturers are forced to sell. The venture's negotiating leverage with buyers may be hampered, or the liquidation may occur at a time when continuing the venture's operations might provide more value because of non-assignable contract rights, tax reasons, or otherwise. The venturers always can decide not to proceed with a contractually mandated liquidation, but that may require unanimity unless the venture agreement provides otherwise.

2. Unilateral Sale of Assets Subject to ROFO/ROFR

Some venture agreements give one or both of venturers a right to cause a sale of the venture's assets, subject to a right of first offer or right of first refusal ("ROFO/ROFR") or some other preemptive right to ensure that the assets are sold for no less than the price, or a percentage of the price, offered or refused by the non-selling venturer. An advantage of this approach is that, depending on how the ROFO/ROFR is drafted, the non-selling venturer has the right to purchase the selling venturer's interest and avoid a sale of the assets if it prefers not to sell. Moreover, the venturer who wants to sell knows that either the venture will sell the assets or the selling venturer will sell its interest. The disadvantages are that the ROFO/ROFR may make it difficult to attract third-party buyers, and the arrangement between the selling venturer and the non-selling venturer often is subject to different interpretations and manipulation that might lead to a dispute. Some venture agreements do not include a ROFO/ROFR, but then as with a liquidation, a loss of value might occur (e.g., loss of non-assignable rights and payment of taxes) that otherwise would be avoided if one of the venturers wants to continue the enterprise. Even with a ROFO/ROFR, a venturer that wants to hold the assets may have no guaranty of the right to buy and continue the enterprise. Although the venturers can draft the ROFO/ROFR to give the non-selling venturer the right to purchase, the selling venturer may want to test the market and may give the non-selling venturer no more than a right to make an offer. If the offer is not accepted, it merely establishes a minimum price for any sale by the selling venturer.

3. Right to Sell Interest in Venture

Some venture agreements give one or both venturers a right to sell their interest in the venture. This may or may not be subject to a ROFO/ROFR (as to the selling venturer's interest), a drag-along right of the selling venturer to force the non-selling venturer to join in the sale, or a tag-along right of the non-selling venturer to join in the sale by the selling venturer. As with

the unilateral right to sell venture assets subject to a ROFO/ROFR, an advantage of this approach is that the selling venturer knows that it will be selling its interest. Also, the non-selling venturer knows that it will not be required to sell and there will be no loss of value attributable to a sale of the venture's assets (except when a drag-along right is implemented). However, a disadvantage is that it is not as easy to sell an interest in a venture as it is to sell the venture's assets. Buyers may insist on a discount for a partial interest and ongoing indemnities for undisclosed venture liabilities and also may request changes to the venture agreement that the non-selling venturer is not required or willing to accept. Moreover, if the venture agreement has a ROFO/ROFR for the sale of interests in the venture, it will present the same issues here as it does in the venture asset sale context, and any tag-along or drag-along rights will raise additional complications, particularly in complex economic structures in which these rights do not always work as the venturers might expect.

4. *Put/Call*

In some ventures, when the venturers know at the outset that one venturer wants to hold the assets long-term and the other venturer wants to liquidate earlier, the venture agreement can provide for a sale of the latter venturer's interest to the former venturer under certain circumstances (which sale may be triggered by either venturer). The advantage of this approach is that the venturer that wants to buy knows it will be the buyer and the venturer that wants to sell knows it will be the seller. This approach also allows for the continuation of the venture. The disadvantage is that a mechanism for establishing the price must be in place, and although numerous formulas and appraisal procedures can be used, they often lead to disputes when it comes time to value the selling venturer's interest.

5. *Closed Auctions*

Another exit strategy is a closed auction between the venturers. For example, each venturer can bid on the value of the venture's assets and the highest bidder may purchase the interest of the other venturer for the amount the other venturer would receive from a sale of the assets at the highest bid. To avoid endless bidding wars, such provisions generally provide for minimum increment bidding.⁴ One sample provision provides

⁴ See Stephen I. Glover, *Negotiating Specialized Internet Access/Exclusive Carriage Agreements*, in NEW STRATEGIES FOR FINANCIAL INSTITUTIONS IN THE E-COMMERCE ECONOMY 2000, at 345, 381, 392-93 (PLI Corporate Law and Practice Course, Handbook

for a minimum increase of \$50,000 and another sample provision provides for an increase of 5%. Presumably, a "minimum" increase was intended; otherwise, there may be additional room for manipulation.⁵ Perhaps the minimum increase should be the lesser of a percentage or dollar amount that is large enough to avoid wasting time, but small enough to avoid an unfair result. Otherwise, using a 5% minimum increment as an example, the obvious ploy of starting with a 97.5% bid, may be too big of an advantage. If the deal has \$200 million of equity and the venturers have equal interests, then the initiating venturer gets either a \$2.5 million discount if it buys or a \$2.5 million premium if it sells. In this example, it seems like the initiating venturer is unfairly rewarded and the element of equity that is supposedly inherent in the risk associated with naming a price is eliminated.

The closed auction process may be reversed if the venturers bid down the value of the venture's assets and allow the lowest bidder to sell its interest for what it would receive from a sale of the assets at the lowest bid. This is a variation of the so-called "Dutch Auction."⁶ However, under this procedure, a venturer who fails to respond with a new, lower offer to sell will be forced to purchase. For enforcement reasons, the preferred process requires venturers to sell, rather than purchase, when they fail to respond.

Another closed auction variation involves taking a single sealed bid from each venturer. For example, the venture agreement might require the venturer with the higher bid to purchase the other venturer's interest for the amount the other venturer would have received from a sale of the venture's assets for a price based on the bid amounts (e.g., the higher of the two bids or the average of the two bids).⁷

The venture agreement also may structure the auction more like a buy/sell by requiring the initiating venturer to name two buy/sell amounts (each indicating a hypothetical price for the venture's assets): a higher amount, which would establish the price at which the initiating venturer would sell its interest to the other venturer, and a lower amount, which would establish the price at which the initiating venturer would purchase the other venturer's interest. The non-initiating venturer would then either choose between the alternatives or suggest two new buy/sell amounts between the prior two buy/sell amounts: a higher amount, which must be less

Series No. B0-00ZA, 2000); Scott A. Lindquist et al., *A Real Estate Lawyer's Guide to Equity Investments*, SF52 ALI-ABA 579, 605 (2001).

⁵ See Glover, *supra* note 4, at 381, 392-93; Lindquist et al., *supra* note 4, at 593, 605.

⁶ See 7 AM. JUR. 2D *Auctions and Auctioneers* § 1 (1997).

⁷ See *Larken Minn., Inc. v. Wray*, 881 F. Supp. 1413, 1415 (D. Minn. 1995) *aff'd*, 89 F.3d 841 (8th Cir. 1996).

than the prior higher amount, to establish the price at which the non-initiating venturer would sell its interest to the first venturer and a lower amount, which must be greater than the prior lower amount, to establish the price at which the non-initiating venturer would purchase the first venturer's interest. This process continues until the venturers agree to purchase or sell or until there is no further room to bid (which can be assured by minimum increment bidding). At that point, the venturer who has no room to bid must decide to purchase or sell. This process is similar to the upward or downward bidding wars mentioned earlier and may have the same problems. Moreover, the first bid conceivably could be the last possible bid. However, the responding venturer has the ability to end the process by either selling or buying, which is unlike the prior bidding situations in which the responding bidder can end the process during its turn only by electing not to bid further and then selling in an upward bidding war or buying in a downward bidding war.

Each of these auctions is similar to, and is sometimes even identified as, a buy/sell. While auctions may be attractive because they can make it more likely that the venturers will find appropriate pricing, the process may be time consuming and complicated, and consequently less certain, especially when more than two venturers are involved.⁸

6. Other Exit Strategies

Countless other strategies are no doubt possible, but further discussion of this subject is beyond the scope of this Article.⁹

D. Pros and Cons of Buy/Sell

With a buy/sell, uncertainty is one drawback. First, without a third-party buyer to test the market, pricing is uncertain; the danger that the pricing will be either too high or too low lurks in the background, and the initiating venturer may end up buying at an inflated price or selling at a discounted price. Second, whether the initiating venturer will be the buyer or the seller

⁸ See, e.g., *Toste Farm Corp. v. Hadbury, Inc.*, 882 F. Supp. 240, 242 (D.R.I. 1995), *aff'd*, 70 F.3d 640 (1st Cir. 1995) (involving a so-called "buy-sell procedure . . . whereby each [partner] could bid for the partnership interest of the other. The bidding ended in a dispute . . . [with each partner claiming] to have acquired ownership of the other's partnership interest").

⁹ For a chart outlining some of the advantages and disadvantages of alternative exit strategies, see J. Ross Docksey, *Designing Joint Venture Exit Provisions*, in *DRAFTING CORPORATE AGREEMENTS* 173, 177-178 (PLI Corporate Law and Practice Course, Handbook Series No. B7-6956, 1996).

is uncertain. The buy/sell does not work well for a venturer who (whether for tax reasons, a shortage of capital, or otherwise) knows that it wants only to buy or only to sell. If a venturer wants to sell, triggering the buy/sell forces that venturer to take the risk that the other venturer elects to sell, and consequently, it may be required to buy the other venturer's interest in order to sell the venture's assets. Similarly, if a venturer wants to buy, that venturer has no assurance that the buy/sell will allow it to do so because the responding venturer may elect to be the purchaser.

On the other hand, a buy/sell may provide finality in the separation process. Unlike the valuation issues presented by the put/call or the interpretation issues associated with a ROFO/ROFR (or a tag-along or drag-along right), a buy/sell can be drafted so that in most circumstances, it appears relatively easy to determine what must be paid to close the transaction and to minimize the likelihood of a dispute. The buy/sell also can be more expeditious than many other exit strategies because it may not be necessary to involve third parties such as appraisers and third-party buyers. Another perceived advantage of the buy/sell is its apparent even-handedness. Finally, as with certain other exit strategies (e.g., a put/call and sales subject to a ROFO/ROFR), the buy/sell may allow the purchasing venturer to continue the venture, retain the value of non-assignable contract rights, and avoid the recognition of some of the gain that might occur from a sale of the venture's assets. The apparent finality, expeditiousness, fairness, and continuity attract many venturers to the buy/sell.

II. TRIGGERS/BLACKOUTS: WHEN IS THE BUY/SELL AVAILABLE?

A. Blackouts

The threat of a buy/sell may be an unnecessary or undesirable distraction at certain times, especially at the inception of the venture when the venturers are trying to establish a working relationship. Consequently, a blackout period during which the buy/sell is not available may be used. This period can run until the expiration of a fixed period of time or the accomplishment of certain tasks such as completion of construction or leasing of certain space. The blackout is particularly important in development deals in which the expertise of one of the venturers during the development period may be key to the success of the project. The blackout period can be different for each venturer and can, for example, include any period during which a venturer is in default.

B. Triggers

Sometimes, the buy/sell is available for any reason after the blackout period. At other times, the buy/sell is available only in specified circumstances, which may be different for each venturer, occurring outside the blackout period. Some of the more common circumstances are described below.

1. Deadlocks

One of the most common circumstances in which a buy/sell is made available is when venturers disagree over certain major decisions. In many agreements, availability of the buy/sell is limited to matters over which reasonable minds may differ, such as deciding whether to proceed with an acquisition, sale or financing, or whether to approve a proposed annual business plan or budget. Other decisions may be excluded from the buy/sell because a deadlock is not likely to have a material adverse effect on the venture or can be resolved in other ways such as arbitration. When a triggering deadlock occurs, a "cooling off" period during which the venturers can discuss the matter before proceeding with the buy/sell is advisable. To further relieve the pressure, some venture agreements require multiple deadlocks within a certain period of time before the buy/sell is available. Does this makes sense for all major decisions (for example, whether to sell the assets of the venture)? Is it too easy to manufacture a dispute?

2. Override Rights

Some joint venture agreements resolve disagreements with an override right, the right of one of the venturers to impose a decision unilaterally despite an objection by the other venturer. In such agreements, it is also possible to make a buy/sell available if and when the override right is exercised. This buy/sell right is often limited to certain fundamental decisions that may lead to a result that is untenable for the other venturer. Thus, a 10% venturer might have the right to trigger a buy/sell if the 90%, or controlling, venturer decides to acquire a new project over the objection of the 10% venturer.

3. Defaults

The buy/sell provision may be a remedy in the event of a default. However, it may not be an advantage to be the one initiating the buy/sell. The defaulting venturer may therefore be required to trigger the buy/sell, although this can create enforcement problems if the defaulting party is not cooperative.

4. *Failure of Performance Standards*

The buy/sell may be available in some venture agreements if certain performance standards (for example, internal rates of return, returns on cost, budget limits or project deadlines) are not met.

5. *Change in Ownership or Control*

The buy/sell also may be available if a change occurs in ownership or control of a venturer, the venturer's interest, or in the active participation of a venturer (because of, for example, bankruptcy, death, disability, merger, or transfer).

III. PRICING

When the buy/sell becomes available, a venturer normally has a certain period of time to begin the process by giving a notice to the other venturer that establishes the pricing. This is perhaps the most important step.

A. Valuing Initiating Venturer's Interest

Many older buy/sell forms stated a price for the initiating venturer's interest and then allowed for an adjustment based on the venturers' relative ownership interests if the responding venturer elected to sell. Consider the following sample provisions:

Basic Right. Each [venturer] shall have the right . . . to require the other [venturer] to purchase its interest in the [venture] or to purchase the [venture] interest of the other [venturer]. The [venturer] initiating [this buy/sell process] shall be referred to as the First Party, and the other [venturer] shall be referred to as the Second Party. . . .

Initiation. The First Party shall initiate the [buy/sell] by giving notice to the Second Party. The notice . . . shall state the exact terms of the proposed sale, which sale must be concluded at a designated time no sooner than 60 and no later than 90 days after the notice. . . .

Response. The Second Party shall have 30 days after receiving the [notice] in which to elect either (a) to purchase the First Party's interest at the stated terms and price or (b) to sell to the First Party the Second Party's interest at the stated terms and price, adjusted according to the [venturer's] Percentage Interest . . .¹⁰

¹⁰ DEE HARTZOG & JOHN E. DIGIUSTO, ADVISING CALIFORNIA PARTNERSHIPS

The following example illustrates how these provisions operate.

Example 1. Assume the following facts: one venturer holds an 80% interest and the other venturer holds a 20% interest in a straight-up 80/20 venture, and the 80% venturer triggers the buy/sell and names an \$8,000,000 price for his interest. Under these facts (and the sample provisions quoted above), the 20% venturer must choose either to purchase the 80% venturer's interest for \$8,000,000 or to sell his interest for \$2,000,000.

This approach may work in certain simple ventures. However, this approach appears to assume that the venturers' interests are proportionate, and this is not always the case. Indeed, it is very common for each venturer to have multiple percentages. For example, many venture agreements provide that distributions are made in the same proportion as contributions until the venturers receive all their capital back, plus a return on their capital, and then the remaining profits are distributed in different proportions. In particular, and most dramatically, the agreement can have subordinations or preferences in which one venturer receives nothing and the other venturer receives 100% of certain distributions.

Example 2. Assume the following facts: a venture agreement between A and B provides that all distributions are to be made to A, the preferred venturer, until A receives \$2,000,000, then to B, the subordinated venturer, until B receives \$2,000,000, and then any balance is distributed 50/50.

Under these facts, what happens if A names a \$2,000,000 price for his interest? Assuming for simplicity that there have been no distributions, determining a single price for B's interest is impossible because A would receive \$2,000,000 from any sale generating distributions between \$2,000,000 and \$4,000,000 (which could yield prices for B's interest ranging anywhere from \$0 to \$2,000,000).¹¹

§§ 5.136, 5.137, 5.138 (Donald R. Briggs ed., 2nd ed. 1998).

¹¹ See J. Ross Docksey, *Joint Venture Agreement*, in DRAFTING CORPORATE AGREEMENTS 103, 129, 160-62 (PLI Corporate Law and Practice Course, Handbook Series No. B7-6956, 1996) (setting forth a general partnership agreement form between corporations in which the prices are determined by multiplying the buy/sell amount by each partner's percentage interest, which may fail (as does Example 2) because some distributions are described in the form that are not made in proportion to the percentage interests, including a preferred return in favor of one of the partners); Frank E. Roegge et al., *Real Estate Equity Investment and the Institutional Lender: Nothing Ventured, Nothing Gained*, in REALTY VENTURES 1987: WORKING IN AND WORKING OUT 43, 111 (PLI Real Estate Law and Practice Course, Handbook Series No. N4-4479, 1987) (stating that "one partner sets a price on the entire partnership or the real estate, and the other partner has the option of either buying the first partner's interest or selling his interest to the first partner at a pro rata percentage of the price set by the first partner").

B. Valuing Assets of Venture

To deal with the problem of valuing venturer interests, most recent venture agreements require that the triggering venturer name a price for the assets of the venture and provide that the price for each venturer's interest equals the amount that venturer would receive if the assets were sold for the named price and the proceeds from the sale were distributed in accordance with the venture agreement.

Example 3. Assume the following facts: one venturer is obligated to contribute 20% of all capital to the venture, and the other venturer is obligated to contribute 80% of all capital to the venture. The 80% venturer has contributed \$8,000,000, and the 20% venturer has contributed \$2,000,000. The venture agreement provides that all distributions are to be made 80/20 until the venturers have recouped all their capital, and any balance is distributed 50/50. The venture agreement provides for a buy/sell under which the triggering venturer names a dollar amount, and the prices for each venture interest are determined by calculating what each venturer would receive if the assets of the venture were sold and a distribution equal to the specified dollar amount were distributed to the venturers.

Under these facts, if the venturers do not make any other contributions or distributions and the 20% venturer is the selling venturer, a \$12,000,000 buy/sell amount would yield a price of \$3,000,000 (\$2,000,000 of the first \$10,000,000 and \$1,000,000 of the next \$2,000,000).

As always, the devil is in the details and the venturers must consider a number of details under this improved formulation, as described below.

C. Initial Value Adjustments

If the venture's assets were actually sold, the venture would incur a number of costs before any distributions were made to the venturers. What are these costs and how are they taken into account? Some venture agreements refer to a hypothetical sale without any further guidance. This may lead to a dispute.

1. Hypothetical Sale Costs

Many agreements deduct the hypothetical costs of a sale of the assets, including brokerage fees, title insurance, prepayment premiums, and transfer taxes, before the hypothetical distributions are made to ensure that the selling venturer does not receive more than it would have received from an actual sale of the assets. How are these costs determined? Transfer taxes may be easy to determine, but brokerage fees and title insurance may be negotiable, and a prepayment or defeasance lockout or amount under a loan

may be difficult to evaluate. Some agreements determine these costs in advance by assuming a fixed percentage of closing costs. The percentage can vary depending on the jurisdiction and facts. For example, transfer taxes, title insurance premiums, and allocation of closing costs between the buyer and the seller vary considerably from state to state. Another possibility is to have no adjustment for sale costs, and simply put the burden on the triggering venturer to make any appropriate sale cost adjustments in advance, by naming a net buy/sell amount.

2. Hypothetical Liquidation Costs

Similarly, the venture normally would be liquidated if all its assets were sold, and the venture would have costs associated with the liquidation (including, for example, the costs of preparing and filing final tax returns and dissolution documents). Will the selling venturer receive too much if the costs of dissolution and liquidation are not deducted? To address this issue, many agreements provide that the prices are determined by the net distributions that would be made after a dissolution and complete liquidation of the venture. How are hypothetical liquidation costs determined? Again, the parties can use a fixed percentage or, better yet, a fixed amount, because the third-party professional costs and fees of a liquidation do not vary significantly for different size ventures. However, third-party professional fees and costs are not the only costs that must be paid upon liquidation. All the creditors of the venture must be paid (including venturers that have made loans to the venture), and anticipating in advance the outstanding amounts due to creditors upon liquidation may be difficult. This may be the most uncertain part of the buy/sell calculation, especially with reserves for contingent liabilities. For example, what happens if, at the time the buy/sell is exercised, an uninsured \$1,000,000 litigation claim has been filed against the venture and the outcome of the claim is far from clear? What should be deducted?

What if the venturers disagree about the calculation of these adjustments? A common solution is to allow the accountants for the venture to determine the pricing and to make the accountants' determination conclusive.

D. Closing Value Adjustments

The final price usually is calculated at the closing of the buy/sell.

1. Contributions and Distributions

As described in further detail below, contributions and distributions be-

tween the commencement and conclusion of the buy/sell often result in an adjustment of the buy/sell amount.

2. Prorations

The buy/sell amount also may be adjusted by prorations, as of the closing, because prorations would be made in a sale of the venture's assets.

3. Recalculation at Closing

The recalculation at closing may take into account, among other matters, any adjustments to the buy/sell amount (such as those mentioned above), which, in turn, can affect the hypothetical closing costs (such as those that are based on a percentage of the buy/sell amount). Even if the buy/sell amount is not adjusted, recalculation at closing may be necessary to determine how much of the buy/sell amount would be used, hypothetically, to pay venture liabilities, which may have increased or decreased by closing, and how the net amount would be allocated¹² under the distribution waterfall (in light of potential interim contributions and distributions or any other interim events, such as a squeezedown or the accrual of a preferred return). For example, a particular interim distribution may not result in an adjustment to the buy/sell amount, but it may change the respective portions of the buy/sell amount distributed to each venturer.¹³

E. Arbitrary Determination of Buy/Sell Amount

Many agreements do not require that the amount specified when triggering the buy/sell have any relationship to the value of the assets of the venture. For simplicity, and to avoid argument, all that may be required is a specific number. In theory, the adverse consequences of specifying an amount that is not based on value (being forced to sell below market if the specified amount is too low and being forced to buy above market if the specified amount is too high) might seem to be adequate incentive to ensure an attempt to approximate value. However, in practice, this apparent equalizer does not always work because, for example, a sale or a purchase may be the more likely choice for a particular party at a particular time for tax or other reasons unrelated to the price. A venturer may be able to take advantage of this likelihood by naming an above-market price if the other venturer is likely to buy or by naming a below-market price if the other venturer is likely to sell.

¹² See Example 3, *supra* Part III.B.

¹³ See Example 8, *infra* Part VI.B.4.

1. *Capital Resource Issues*

If a particular venturer does not have sufficient capital to make a purchase, then the venturer may be forced to sell. Although the issue of raising capital to purchase under a buy/sell may be an issue in any case, as described below, the issue is exacerbated by the prospect of an arbitrary lowball bid. Some commentators have suggested that an auction may be preferable to a buy/sell because an auction gives "each party . . . some ability to bid up a low price."¹⁴ However, it is not clear what good this does if a venturer cannot perform. In *Larken*, venturers used a sealed bid auction in which the winning bidder was to purchase the losing bidder's interest based on an average of the two bids.¹⁵ The higher bidder was not able to perform, and the court threw out the bid altogether and allowed the other bidder to purchase the higher bidder's interest based on the lower bid, despite the claim that the lower bid was substantially below market.¹⁶ If a venturer cannot perform as a buyer, it is likely to be a seller.

2. *Preference/Subordination Issues*

If preferences or subordinations are present, the results may be surprising.

Example 4. Assume the following: as in Example 2,¹⁷ the first two levels of distributions in the venture agreement between A (the preferred venturer) and B (the subordinated venturer) are first \$2,000,000 to A and then \$2,000,000 to B. At the time in question, the venturers have made no distributions and the fair market value of the venture's assets is approximately \$3,000,000.

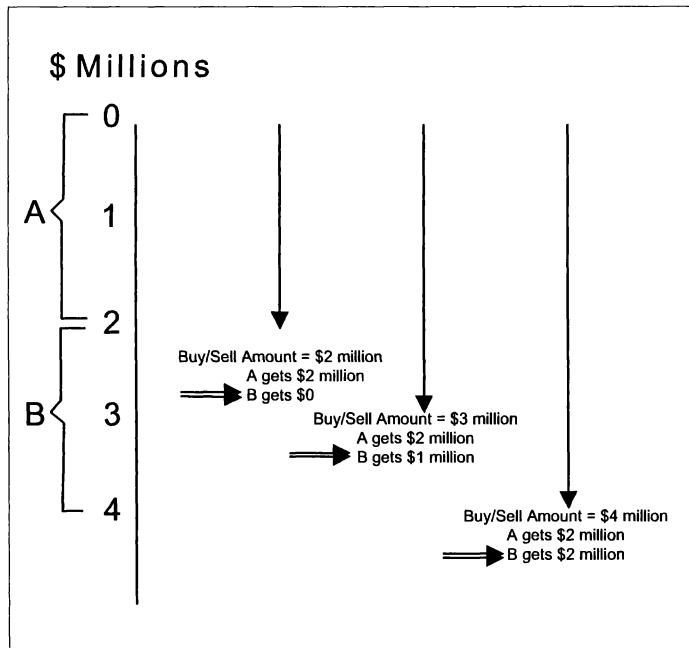
Assuming further that there are no value limitations, then A can name a buy/sell amount of \$2,000,000. Suddenly, the buy/sell looks more like a "put right" because B faces a Hobson's choice: either purchasing A's interest for \$2,000,000 (the only viable alternative) or selling his interest for nothing!

¹⁴ Lindquist et al., *supra* note 4, at 593.

¹⁵ *Larken Minn.*, 881 F. Supp. at 1413.

¹⁶ *Id.* at 1417, 1421.

¹⁷ See *supra* Part III.A.



Contrary to the assumptions underlying the buy/sell, there is not always a built-in deterrent in place to discourage the initiating venturer from specifying a below-market buy/sell amount. In Example 4, in which A, the preferred venturer, names a below-market buy/sell amount, a below-market amount does not necessarily expose the initiating venturer to the risk of selling its interest at a discount. This is obviously dangerous for B, the subordinated venturer; and such a preferential/subordinated distribution scheme also may be dangerous for A, the preferred venturer. Indeed, for similar reasons, a built-in deterrent may not always be in place to discourage the initiating venturer from specifying an above-market buy/sell amount. In Example 5, in which B, the subordinated venturer, names an above-market buy/sell amount, an above-market amount does not necessarily expose B, the initiating venturer, to the risk of purchasing the other venturer's interest for an inflated price.

Example 5. Assume the same facts as Example 4. If B (the subordinated venturer) names a \$4,000,000 buy/sell amount, the buy/sell begins to look more like a "call right" because A (the preferred venturer) must choose between a sale of his interest for \$2,000,000 (the only viable alternative) or a purchase of B's interest for \$2,000,000, which is twice as much as B, the subordinated venturer, would receive from a sale at fair market value!

So much for checks and balances. As illustrated by Examples 4 and 5, if a sale at the current value of the venture's assets would result in distributions within, but not beyond, a distribution level that gives 100% to one venturer (the participating venturer), then the venture may be in a danger zone. As the buy/sell amount varies within that level, the price for the nonparticipating venturer's interest is fixed, and only the price of the interest of the participating venturer will fluctuate. This is contrary to an implicit assumption underlying the buy/sell process: increasing or decreasing the buy/sell amount will increase or decrease the price for the interests of both members. This oddity makes likely the possibility that, when in the danger zone, the participating venturer's interest (the only interest whose price varies within this level) will not be sold, and the participating venturer will end up being the buyer. This occurs because pricing is not an exact science, and if some error is made, the initiating venturer will err in a manner that does not hurt it:

1. If the nonparticipating venturer were to initiate the buy/sell, that venturer likely would estimate in favor of a lower buy/sell amount. This lower amount would decrease the price of the interest of the participating venturer without changing the price of its own interest, making it more likely that the participating venturer would not want to sell (to avoid selling at a discount) and that the participating venturer would be the buyer; and
2. If the participating venturer were to initiate the buy/sell, that venturer likely would estimate in favor of a higher buy/sell amount. A higher amount would increase the price of the participating venturer's interest without changing the price of the interest of the nonparticipating venturer, which makes it more likely that the nonparticipating venturer would not want to purchase (to avoid overpaying) and would sell instead.

Given this bias, venturers will be tempted to push the limits of the buy/sell agreement to take full advantage of the disparate treatment, especially if there are no restrictions on the buy/sell amount that may be declared.

3. *Tax Issues*

A venturer may have a strong disincentive to sell if a sale will result in the recognition of a significant gain. For example, if one of the venturers contributed property with a low basis to the venture, the venturer would

have acquired a correspondingly low basis in its venture interest.¹⁸ Over time, that venturer may end up with a negative capital account, while the other venturer is still positive. When the venturer with a negative capital account sells its interest, it may have more gain than cash. Unless the venturer can bargain for an exchange structure (for example, a co-tenancy arrangement), the venturer may be more inclined to purchase under a buy/sell to avoid the gain.

4. *Generally*

Venturers may have countless other reasons to favor a purchase over a sale or vice versa. A venturer may be downsizing or moving from real estate to liquid assets. Perhaps one of the venturers is attempting to control the market and is unwilling to risk having the other venturer acquire the venture's assets. A sale by one of the venturers may not be a practical alternative if that venturer controls the name of the project or a lender will not permit that venturer to leave the project. Any reason may tip the scales and allow for mischief in an otherwise balanced buy/sell. If a venturer is strongly inclined to take only one course (either to buy or to sell), then the buy/sell may effectively become a call right or put right in favor of the other venturer:

- (a) A venturer may be effectively precluded from exercising the buy/sell because that venturer may be unwilling to take the risk that the other venturer will force it to follow a different course of action; and
- (b) The other venturer's exercise of the buy/sell may force the venturer to take the likely course of action.

To the extent such circumstances can be anticipated, the venturers may be better off without a buy/sell and should consider a put/call or some other exit strategy.

F. Value Determination of Buy/Sell Amount

Not all buy/sell arrangements permit an arbitrary determination.

1. *Good Faith Estimate*

One approach is to require that the buy/sell amount be the triggering venturer's good faith estimate of the value of the venture's assets, but this may be difficult to enforce, except in egregious cases. Does a venturer have

¹⁸ I.R.C. § 722 (2000).

a fiduciary duty or a good faith obligation to do so? In *Johnson v. Buck*,¹⁹ one of two general partners in a 50/50 real estate venture offered to buy the other partner's interest for \$1,500,000 or to sell his interest for the same amount. After some discussion, the other partner agreed to sell his interest for \$1,750,000.²⁰ The trial court apparently accepted evidence that the offering partner specified an amount below market because he knew that the other partner did not have the capital to buy him out.²¹ The appellate court affirmed the judgment of the trial court that set aside the sale.²² However, in this case, no buy/sell procedure was set forth in the venture agreement, and the initiating venturer misrepresented the financial status and prospects of the venture and made misleading statements as to whether a major retailer would ever become an anchor in the partnership's shopping center.²³ The result might have been different in the absence of misrepresentation if specific buy/sell provisions were included.²⁴ In *Larken* the court found that the express provisions of a partnership agreement did not require the buy/sell price to "bear any relationship to fair market value" (under a so-called buy/sell provision that contemplated sealed bids and then required the highest bidder to buy the other bidder's interest based on the average of the two bids) and did not find any breach of fiduciary duty for a bid that was purportedly substantially less than the fair market value.²⁵ "[I]t is difficult to see how an action taken directly pursuant to the express terms of the partnership agreements, i.e., the submission of a bid that meets the requirements of the [partnership agreements] could constitute a breach of fiduciary duty"²⁶

¹⁹ 540 S.W.2d 393, 400 (Tex. App. 1976).

²⁰ *Id.*

²¹ *Id.* at 411.

²² *Id.* at 418.

²³ *Id.* at 400.

²⁴ See, e.g., DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c) (1999) [Article 17, Delaware's Limited Partnerships Act, hereinafter "DRULPA"]; see also discussion *infra* Part X.C.

²⁵ *Larken Minn.*, 881 F. Supp. at 1421.

²⁶ *Id.*; see also Noel W. Nellis & William G. Murray, *Negotiating, Drafting and Operating Under a Real Estate Joint Venture Agreement: Major Provisions and Issues*, in THE REAL ESTATE PARTNERSHIP IN DEFAULT 1990: UP-FRONT PROTECTIONS—WORKOUTS AND BANKRUPTCY 63, 108-09 (PLI Real Estate and Practice Course, Handbook Series No. N4-4541, 1990). But see *Schafer v. RMS Realty*, 741 N.E.2d 155, 175-76 (Ohio Ct. App. 2000) (involving an alleged wrongful capital call made in accordance with a partnership agreement, in which the court acknowledged that as a general proposition, the partnership agreement controls, but stated that "actions taken in accordance with a partnership agreement can still be a breach of fiduciary duty if partners have improperly taken advantage of

2. *Appraisal Limits*

Venturers also can use appraised value limitations (for example, that the buy/sell amount may not be less than 90% or more than 110% of the appraised value of the venture's assets). However, the appraisal process may be cumbersome and time-consuming and if the appraisal is significantly higher or lower than a venturer's determination of value, it may preclude an exercise of the buy/sell.

G. Access to Capital

Many nonfinancial venturers are concerned that they may not be able to raise the capital to become buyers under the buy/sell and consequently may be forced to sell their interests for less than what they are worth. This problem has many potential solutions, one or more of which are frequently requested, but most of which are seldom used. These solutions are discussed below.

1. *Buy/Sell Amount Based on Value*

As described earlier, the parties may be required to base the buy/sell amount on their estimated value of the venture's assets, or alternatively, may be precluded from using a buy/sell amount that is less than some percentage of the appraised value to limit any potential loss to the selling venturer. However, this may make the buy/sell a less certain and less expeditious remedy. Moreover, although these value requirements may minimize the likelihood that the responding venturer will be penalized if it elects to sell, such requirements do not make the prospect of a purchase more viable. If a venturer cannot raise the capital to consummate a below-market purchase, the venturer would fare even worse as a buyer in a market transaction.

2. *Minimum Buy/Sell Amount Based on Capital*

The parties instead may be precluded from using a buy/sell amount that is less than the total unrecouped capital in the venture (and perhaps a minimum return on that capital). Like the value-based solutions discussed above, this may make a sale less painful, but it does not help the non-financial venturer with a purchase. Moreover, it may effectively eliminate the buy/sell when the value of the venture's assets is actually less than this minimum amount.

their position to obtain financial gain").

3. *Seller Financing*

The selling venturer may be required to offer seller financing. However, this prolongs the venturer's relationship, which the parties may have intended to end through the buy/sell process, and raises difficult questions of post-closing enforcement, financing terms (including security), and lender controls.

4. *Allowing Sale of the Project*

The buy/sell provision may allow the purchasing venturer to sell the project to a third party at a price that generates net proceeds to the selling venturer equal to (or greater than) what the selling venturer would have received had its interest in the venture been sold pursuant to the buy/sell. However, this involves many of the complications associated with a unilateral sale of the venture's assets subject to ROFO/ROFR, as discussed above. For example, issues over the terms of the sale contract may arise, which could increase the contingent liabilities of the venture because surviving seller representations may not be required in a sale between venturers. What happens if the venturers disagree about the appropriate amount of reserves that should be set aside to deal with their contingent sale contract liabilities, especially if the amount the selling venturer believes is required would result in an unpermitted sale because the selling venturer would not receive adequate proceeds?

5. *Blackout through Stabilization*

In rental income-producing development projects, some venture agreements provide a blackout under the buy/sell through stabilization so that no venturer is forced to purchase prior to stabilization, at a time when the value of the assets is not likely to be fully realized by a loan or purchase. But what happens if the project never stabilizes?

6. *Increasing Response Time*

The most common solution to the capital resource problem is simply to give the non-initiating venturer sufficient time to obtain financing or other capital before responding to the buy/sell.

H. Access to Information

Although the venturers may not have equal access to capital, some venture agreements attempt to create equal access to information by imposing express disclosure obligations for inquiries relating to the sale of the project. Do fiduciary and other duties mandate this result, and if so, are such

duties negated by express provisions to the contrary? The extent of any duty to disclose may depend not only on the governing law and the terms of the venture agreement, but also on the relevant factual circumstances, including the degree to which the venturers have access to accurate financial records, whether the non-disclosing venturer managed the business, and whether the non-disclosing venturer was knowledgeable and sophisticated.²⁷

I. Avoiding Embarrassment

Sometimes one or both venturers will seek protection against an embarrassing loss under the buy/sell, whether the loss was because of a disadvantage in capital resources, liquidity or expertise, manipulation, or just bad timing. For example, if the buy/sell trigger was that entitlements were not obtained by a certain point in time and one venturer initiated the buy/sell for that reason, one form of protection might be a right of the selling venturer to buy back its interest at cost if the entitlements were obtained within a short period of time after the buy/sell closing. Another example might be a buy/sell in which the selling venturer gets to share in the profits if there is a sale of the venture's assets for more than the buy/sell amount within a short period after the buy/sell closing. Sometimes this protection is limited to a selling venturer who did not trigger the buy/sell. This makes sense because the triggering venturer arguably put itself into danger by initiating the buy/sell. Moreover, in the second example above, there is a difference between a venturer who triggers the process and names too low a price and a poor venturer who did not recognize he was being offered a great deal, or, more significantly, did not have the resources to capitalize on it. However, if the goal is not to look foolish—especially in the case of a public company—it may make sense to have protection available regardless of who triggers the buy/sell. This protection is not very common and may not be desirable because it prolongs the relationship that the buy/sell is intended to end.

²⁷ See, e.g., Aug. 1, 2001 amendments to the following Delaware statutes: DEL. CODE ANN. tit. 6, §§ 15-103(b)(2), 15-403(f) (Supp. 2002) [Article 15, Delaware's Revised Uniform Partnership Act, hereinafter "DRUPA"]; DRUPLA § 17-305; DEL. CODE ANN. tit. 6 § 18-305 (Supp. 2002) [Article 18, Delaware's Limited Liability Company Act, hereinafter "DLLCA"]; see also *Walter v. Holiday Inns, Inc.*, 985 F.2d 1232, 1239 (3rd Cir. 1993) (finding no breach of fiduciary duty in a negotiated buy-out by a managing partner when the non-managing partner was on the executive committee, had access to the relevant information and was sophisticated); discussion *infra* Part X.B.3.

J. Negative Values

What if an actual sale of the venture's assets at the buy/sell price would result in the selling venturer's paying, rather than receiving, money (whether because of a deficit restoration obligation, a loss guaranty, or otherwise)? Under these circumstances, the selling venturer may end up with a negative purchase price. Is the selling venturer obligated to pay if the document is not clear on this point?²⁸

K. Capital Accounts

Some venture agreements provide for liquidation in accordance with capital accounts, an example being venture agreements involving pension funds that want to comply with the exception to unrelated business taxable income for leveraged real estate investments under Internal Revenue Code ("Code") section 514(c)(9).²⁹ Another example is a venture in which there are special allocations of taxable income or loss. If the venturers intend that the buy/sell prices are to be determined as though the property were sold and the venture liquidated, the venture agreement should be clear as to how this is done. Liquidation in accordance with capital accounts may yield distributions different from the distribution waterfall that applies prior to liquidation. Indeed, if the venture agreement requires liquidation in accordance with capital accounts, then failure to calculate the prices for each venturer's interest through a hypothetical liquidation in accordance with capital accounts may undermine the venture's tax allocations and artificially inflate the price of one venturer's interest (and correspondingly deflate the price of the other's interest).

IV. WHAT IS BEING SOLD?

A buy/sell typically involves a sale of one venturer's interest in the venture to the other venturer. However, this is not always the case, and even when it is, the parties need to examine the assets and liabilities associated with the interest being sold carefully.

A. Sale of Venture Assets vs. Sale of Selling Venturer's Interest

Some buy/sell provisions provide that the purchasing venturer acquires the venture's assets from the venture. Generally, including this type of

²⁸ See, e.g., *Brown v. Union Station Venture Corp.* No. P-5, 727 A.2d 878 (D.C. 1999) (upholding a lower court's interpretation of an ambiguous contract reimbursement provision making the seller liable for reimbursement to the buyer).

²⁹ I.R.C. § 514(c)(9) (2000).

provision is not a good idea. Venturers must consider several points.

1. *Transfer Taxes*

Many states, counties, and cities impose transfer taxes on the transfer of real estate.³⁰ Depending on the jurisdiction and, in some cases, the size of the selling venturer's interest, these transfer taxes may be avoided in the case of a transfer of the selling venturer's interest.³¹

2. *Reassessment*

A transfer of the venture's assets also may result in a reassessment for real estate tax purposes. In California, the reassessment would be automatic upon a change in ownership unless an exemption applied.³² Again, depending on the facts and jurisdiction, the venturers may avoid the reassessment by selling a venturer's interest. In California, a reassessment occurs in connection with a sale of a partnership or LLC interest if it results in the acquisition of a direct or indirect majority ownership interest.³³ This may be a problem when the minority venturer becomes the purchasing venturer under a buy/sell involving California real estate.

3. *Loss of Title Insurance*

The sale of the venture's real estate normally results in a loss of the venture's title insurance insofar as the buyer is concerned. Even the venture may lose its coverage unless the venture provides a warranty deed or purchase money mortgage and the venture or its successor remains intact to enforce the policy.³⁴ However, as discussed below,³⁵ the sale of a venture

³⁰ See, e.g., CAL. REV. & TAX. CODE § 11911 (West 1994); LOS ANGELES, CAL., MUNICIPAL CODE § 21.9.2 (2002).

³¹ See, e.g., CAL. REV. & TAX. CODE § 11925(b) (West Supp. 2004); LOS ANGELES, CAL., MUNICIPAL CODE § 21.9.8(b) (2002) (both of which provide for a transfer tax in the case of the sale of a partnership interest only when the sale results in a termination of the partnership for tax purposes under Code section 708). Under Code section 708(b)(1):

[A] partnership [for tax purposes] shall be considered as terminated only if (A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or (B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

³² CAL. REV. & TAX. CODE §§ 60, 110.1(a)(2).

³³ CAL. REV. & TAX. CODE § 64(c).

³⁴ See, e.g., ¶ 2 Conditions and Stipulations, American Land Title Association Owner's Policy, 1970 Form B (on file with author).

³⁵ See *Fairway Dev. Co. v. Title Ins. Co. of Minn.*, 621 F. Supp. 120 (N.D. Ohio 1985); see also text accompanying note 46, *infra*.

interest may also result in a loss of title insurance if the venture does not take appropriate precautions.

4. *Violation of Financing Restrictions*

Most loan documents contain due-on-sale clauses that are triggered by a sale of the venture's assets. Even if the loan documents contain a one-time transfer right, the venture may be required to pay the lender the required assumption and transfer fees. Depending on the terms of the loan documents, the sale of the selling venturer's interest may avoid an acceleration of the venture financing and payment of associated prepayment penalties or assumption and transfer fees.

5. *Non-assignable Venture Rights*

To the extent the venture has non-assignable contracts, entitlements, permits, licenses, or other rights, these rights may not benefit the new owner of the venture's assets. In these circumstances, the purchasing venturer will want to maintain control of the venture to retain these rights.

6. *Income Taxes*

A sale of the venture's assets will trigger recognition of all of the built-in gain in those assets, but the sale of the selling venturer's interest may defer the gain on the purchasing venturer's interest. Moreover, if the purchasing venturer owns more than a 50% interest in capital or profits, then, depending on the nature of the venture's assets, the gain from the sale of the venture's assets may be ordinary income.³⁶ Although a sale of the selling venturer's interest, if it involves 50% or more of the capital and profits of the venture, may trigger a termination for tax purposes under Code section 708,³⁷ the consequences are not likely to be as severe as in the case of a sale of the assets.

7. *Enforceability*

On the other hand, the purchase of the venture's assets from the venture may be more enforceable than a purchase of a venturer's interest, both because a venturer's interest is personal property (as opposed to real property) and because the bankruptcy of the non-purchasing venturer may not be as problematic if the seller is the venture.³⁸ (However, consider whether a

³⁶ I.R.C. § 707(b)(2)(A) (2000).

³⁷ I.R.C. § 708(b)(1)(B).

³⁸ See Marvin Leon, *Commonly Utilized Partnership Buy-Sell Provisions May Be Unenforceable*, CAL. REAL PROP. J., Spring 1994, at 20.

sale of the venture's real estate to the purchasing venturer should be treated differently than a sale of the selling venturer's interest if the result is 100% (indirect) ownership and control of the real estate by the purchasing venturer. Moreover, are damages an adequate remedy if the venturers have irreconcilable differences and need to separate?) Also, if the real estate is acquired directly, the purchasing venturer will not be subject to liens and other encumbrances on the selling partner's interest.

B. Selling Venturer Interest—Assets

In addition to the selling venturer's right to distributions from the venture, which is considered in the buy/sell formula, the selling venturer may have other rights relating to the venture, or even the purchasing venturer. For example, the selling venturer may have made a loan to the venture or the purchasing venturer. The selling venturer may be providing services to the venture, either directly or through affiliates, and may be entitled to compensation for those services. The selling venturer may even have tort claims against the venture or the purchasing venturer. The selling venturer also may have the apparent authority to bind the venture. What will happen to these rights? Will they be transferred to the purchasing venturer? Will the selling venturer be adequately compensated?

1. *Rights Under Venture Agreement*

Will the selling venturer transfer all its rights under the venture agreement? Maybe not. As discussed below, the selling venturer may want to retain its rights to indemnification from the venture; the selling venturer may also want to cash-out any loans it has made under the venture agreement to the venture or the purchasing venturer (to the extent they are not taken into account in the buy/sell formula).

2. *Fees and Other Rights with Respect to Services*

If the selling venturer is providing services, either directly or through an affiliate, or is otherwise entitled to fees, then the selling venturer will want appropriate compensation, and either or both venturers may want to terminate such service agreements. However, even though the venturers want to part ways as co-owners, it does not necessarily follow that either or both venturers will want to terminate all their service relationships. Service relationships may not be as complicated and may not involve the same issues (such as how and when to finance or sell) that can make a venture so difficult. Moreover, either venturer may be happy to retain a favorable service agreement at the expense of the other, and the ongoing fee revenues

may be more important to the service provider than the fact that it may be dealing with an unhappy owner. In any case, the venturers should consider at the outset whether any service agreements with a venturer or an affiliate should be terminable upon closing of the buy/sell; otherwise, they may be unhappily surprised.

3. *Tort Claims Against Venture or Purchasing Venturer*

A mere assignment of the selling venturer's rights, title, and interest in the venture may not be sufficient to transfer the selling venturer's tort claims against the venture or the purchasing venturer.³⁹ Although mutual releases are possible, many venturers may not want to agree in advance to relinquish these claims.

4. *Other Rights Against Venture or Purchasing Venturer*

Does the selling venturer have other rights against the venture or the purchasing venturer (such as under separate loan agreements, non-compete agreements, rights of first refusal, option agreements, or strategic alliance agreements)? If so, these rights should be addressed.

5. *Rights to Bind Venture*

What happens to the selling venturer's apparent authority to bind the venture? For example, RUPA section 702 provides that a partnership may be bound by the acts of a disassociated partner for two years after disassociation under certain circumstances.⁴⁰ This protection for third-party creditors is not eliminated by assignment. However, this period can be shortened to ninety days by filing a statement of disassociation.⁴¹

C. Selling Venturer Interest—Liabilities

The selling venturer may have various obligations and liabilities to the venture, the purchasing venturer, or third parties. What will happen to these obligations and liabilities? Naturally, the selling venturer will want to leave them behind.

³⁹ See 1 MILTON R. FRIEDMAN, *CONTRACTS AND CONVEYANCES OF REAL PROPERTY* § 2.3 (6th ed. 1998) (citing cases to support the proposition that the assignment of a sale contract does not necessarily assign all rights of the seller in connection with the contract (such as a claim for fraud)).

⁴⁰ RUPA § 702, 6 pt. I U.L.A. 180 (2001).

⁴¹ RUPA § 704, 6 pt. I U.L.A. 186 (2001); see also discussion *infra* Part X.

1. Liabilities Under Venture Agreement

The selling venturer will want to cut off liability for obligations accruing under the venture agreement after the buy/sell closing except those pursuant to the buy/sell provisions. On the other hand, the selling venturer's liability for pre-closing obligations generally is not released. In particular, as discussed below, the purchasing venturer will want the selling venturer to satisfy fully at the buy/sell closing any loans under the venture agreement to the selling venturer from the venture or the purchasing venturer (to the extent these loans are not satisfied through the calculation and payment of the buy/sell price).

2. Other Liabilities to Venture or Purchasing Venturer

Does the selling venturer or its affiliates have other liabilities to the venture or purchasing venturer (such as obligations under separate loan agreements, indemnities, non-compete agreements, rights of first refusal, option agreements, strategic alliance agreements, or service agreements)? If so, these obligations and liabilities should be addressed through termination of service agreements or otherwise.

3. Liabilities to Third Parties on Behalf of Venture

The selling venturer may have obligations to third parties that were incurred for the benefit of the venture. For example, the selling venturer may have executed a guaranty of nonrecourse carve-outs or an environmental indemnity in connection with a loan to the venture, or provided credit support for a letter of credit, bond, or similar credit enhancement given on behalf of the venture. The selling venturer will not want continuing responsibility for these liabilities. Consequently, many buy/sells require a release or adequate indemnification. Also, if the selling venturer is a general partner in a partnership, it may continue to have liability for partnership obligations incurred during a certain period after the buy/sell closing. For example, RUPA section 703 provides that this period is two years under certain circumstances;⁴² however, according to RUPA section 704, this period can be reduced to ninety days if a statement of dissociation is filed when the buy/sell closes.⁴³ Finally, the selling venturer may want any indemnification by the venture for venture liabilities to remain in effect after the closing of the buy/sell.

⁴² RUPA § 703, 6 pt. I U.L.A. 183 (2001).

⁴³ RUPA § 704, 6 pt. I U.L.A. 186 (2001).

4. *Other Liabilities to Third Parties*

The selling venturer also may have liabilities to third parties that were not incurred on behalf of the venture, but that affect the venturer's interest in the venture. For example, the selling venturer may have granted a lien to another party to secure a loan to the selling venturer. Most buy/sell agreements require a conveyance of the selling venturer's interest free and clear of all liens. If the selling venturer is a single-purpose entity with no assets other than its interest in the venture, a title warranty provides little comfort on this issue. Moreover, restrictions in the venture agreement may not effectively prohibit hypothecation (assuming the interests of the venturers are general intangibles).⁴⁴ One solution to this problem is for each of the venturers to grant the other at the time of the venture formation a first priority security interest in the other's venture interest to secure its obligations under the venture agreement.

D. *Venturer Loans*

What if a venturer has made a loan to the other venturer or the venture (for example, in connection with the other venturer's failure to make contributions)? What if the venture has made a loan to a venturer (for example, to pay income taxes)? Some venture agreements provide that no distributions should be made until all venturer loans to the venture are satisfied, and any distributions to a borrowing venturer are diverted to the other venturer or the venture to satisfy any loans to such borrowing venturer. Even so, the buy/sell amount may not be sufficient to satisfy all venturer loans to the venture, and the hypothetical buy/sell distributions to the borrowing venturer may not be sufficient to satisfy the borrowing venturer's loans. Venturers should take care to avoid inadvertently losing these loans in connection with the buy/sell as a presumptive settlement.⁴⁵ If loans between a venturer and another venturer or the venture are contemplated by the venture agreement, then the parties should consider providing that any such loans be satisfied at the buy/sell closing (to the extent they are not satisfied through the calculation and payment of the buy/sell price), although this may further exacerbate the capital resource issue discussed above.

⁴⁴ U.C.C. § 9-408 (1999). *But cf.* DRUPA § 15-104 (Supp. 2002), DRULPA § 17-1101 (Supp. 2002), DLLCA § 18-1101 (Supp. 2002).

⁴⁵ See *Zedrick v. Kosenski*, 380 P.2d 870 (Wash. 1963).

V. OTHER TERMS OF SALE

The other terms of the sale are worth determining in advance. These terms are considerably easier to negotiate before the venturers know who is selling and who is buying. By having a complete and definitive agreement, there is less chance for dispute.

A. Deposit

Many buy/sells require the purchasing venturer to make a deposit of a certain percentage of the purchase price. Frequently, the purchasing venturer delivers the deposit directly to the selling venturer (as opposed to an escrow). As a result, the purchasing venturer does not benefit from any interest on the deposit. A deposit requirement is often, but not always, accompanied by a liquidated damages remedy (as described below) if the purchaser fails to close, but this may defeat the purpose of the buy/sell (to effectuate a divorce). A deposit also makes a venturer think twice about purchasing rather than selling. Sometimes the venturer initiating the buy/sell procedure must make the deposit, which is refunded if the initiating venturer becomes the selling venturer.

B. Terms of Payment

As noted earlier, venturers who do not have ready access to capital will often request that the purchase price be paid over time through seller financing. Sellers normally resist these requests. The typical arrangement is an all cash purchase price payable by wire transfer at closing.

C. Conditions and Termination Rights

Generally, the purpose of the buy/sell would be defeated if the sale is not consummated, and for this reason, termination rights and closing conditions are rare. For example, a due diligence period in a buy/sell is uncommon because the venturers usually are already familiar with the venture. Nonetheless, a venturer may ask for some period of time to obtain financing. What happens if financing is not obtained? Does the purchasing venturer change its election and become a selling venturer? This issue is normally resolved by extending the election period during which the non-initiating venturer must determine whether to buy or sell.

What about a casualty? A condemnation? A loan default? A tenant bankruptcy? If the purchasing venturer is a non-managing venturer, should the purchasing venturer be entitled to tenant estoppel certificates or similar protections to get better information? In some cases, these may be difficult questions, but if the goal is finality, these and other conditions typically are

not included.

D. Representations

Title warranty representations (regarding the selling venturer's interest) and possibly due organization, authorization, execution, and delivery representations are usually the only representations made in connection with a buy/sell. But how does a non-managing venturer purchaser protect itself from what the managing venturer may have done to create venture liabilities? Most managing venturers will resist any attempt to increase the obligations they already have under the venture agreement, but they may be willing to include an explicit statement that the closing of the buy/sell will not relieve any venturer from a breach under the venture agreement occurring prior to the closing.

E. Time and Location of Closing

The agreement should provide for a closing date. The purchasing venturer may specify this date within a certain fixed period of time or the date may be fixed in advance. The agreement also should identify the location of the closing or provide that the closing will occur by mail or through escrow.

F. Closing Costs

The buy/sell should address the allocation of actual closing costs in connection with the sale of the selling venturer's interest (as contrasted with the hypothetical costs of the sale of the venture's assets). Even in a transfer of a venture interest, transfer taxes, escrow charges, and other costs may occur.

G. Title Insurance

Normally, a new title policy is not obtained in connection with a buy/sell. However, a transfer of an ownership interest may have an effect on title insurance.⁴⁶ To avoid this issue, a *Fairway* endorsement can be obtained when the venture obtains its original title insurance policy.

VI. EXECUTORY PERIOD

Once the buy/sell is triggered, and especially after the venturers determine who is selling and who is buying, the relationship of the venturers changes significantly. In California, for example, case law suggests that

⁴⁶ *Fairway*, 621 F. Supp. at 120.

under some circumstances an agreement to sell one partner's interest to another partner may be tantamount to consummating the sale and may terminate their fiduciary duties to one another as partners.⁴⁷

The interim period—sometimes called the “executory period”—between the time the buy/sell is exercised and the time the buy/sell closes can be a dangerous time. The selling venturer, for all practical purposes, may have turned its attention elsewhere. Yet what takes place during this period may have a significant effect on the venture and the ultimate pricing under the buy/sell.

A. Decision-Making

How should decisions be handled during the executory period? When the venturers determine who is selling, should the selling venturer retain all its voting rights? If the selling venturer is the managing venturer, should it continue to manage? Should the purchasing venturer be given additional voting rights to ensure that the venture's assets and liabilities are not substantially changed during this period? These questions have no set answers, and they should be considered at the inception of the venture to avoid unwelcome surprises when the buy/sell is triggered. One possibility is to prohibit new material contracts or other material voluntary changes during this period unless the venturers agree otherwise, but the venturers should be careful not to become so passive or restrictive that it negatively affects the value of the venture's assets.

B. Contributions

How should the venturers treat capital contributions during this period? Usually, the venturers take one of the following approaches.

1. *Prohibiting Contributions*

Some venture agreements do not permit contributions while the buy/sell is in process. However, this may not be in the interest of the purchasing venturer to the extent that the venture requires capital to operate, maintain, or protect its assets. Consider, for example, the need to pay leasing costs for a favorable lease that may not wait until the conclusion of the buy/sell.

⁴⁷ See, e.g., *Lund v. Albrecht*, 936 F.2d 459, 463 (9th Cir. 1991) (citing *Stone v. Millstein*, 804 F.2d 1434, 1438 (9th Cir. 1986) (citing *Wise Realty Co. v. Stewart*, 146 P. 534, 538 (Cal. 1915))); cf. CAL. CORP. CODE § 16603 (West 1990) (“Upon a partner's dissociation . . . [t]he partner's duty of loyalty . . . terminates.”).

2. *Allocating to Purchasing Venturer at Closing*

Another possibility for some contributions, such as leasing costs, is an approach similar to what is used in many real estate purchase contracts. This approach allocates this cost to the buyer (i.e., requiring the purchasing venturer to give a closing credit to the selling venturer for the selling venturer's share of this cost so that the purchasing venturer bears, as of closing, one hundred percent of this cost) and gives the buyer appropriate approvals before the obligation is incurred. However, unlike a typical real estate purchaser, the purchasing venturer under the buy/sell is also part of the owner, so the purchasing venturer may also want a right to require the expenditure and corresponding contribution. This solution may not work for all capital contributions (for example, in the case of a contribution to make a required principal payment under a loan or to pay for operating deficits). What about cost overruns?

3. *Increasing Buy/Sell Amount and Redoing Calculations*

Perhaps the most common solution to the contribution problem is to increase the specified buy/sell amount, or the amount that runs through the distribution waterfall to determine the purchase price, and to redo the calculation of the purchase price. The theory is that the contribution increases the value of the assets of the venture. The results will be similar to the previous approach, assuming capital is recouped through distributions in the same proportion that it was contributed, and will be the same in a straight-up venture in which contributions and distributions all are made in proportion to venture percentages that are fixed throughout the life of the venture. Consider whether this approach, like the previous one, is not appropriate for all contributions.

4. *Redoing Calculation at Closing*

Even if the venturers do not agree to increase the buy/sell amount by the amount of a particular interim contribution, the contribution may change the venturers' respective shares of the net value of the venture's assets.

Example 6. Assume the same facts in Example 3,⁴⁸ but with a \$500,000 interim contribution, of which the purchasing venturer contributes \$400,000 and the selling venturer contributes \$100,000. If the venturers calculate the price again at closing (without increasing the buy/sell amount), the price for the 20% venturer's interest would be reduced by \$150,000 because the 20%

⁴⁸ See *supra* Part III.B.

venturer would be entitled to only \$2,850,000 (\$2,100,000 of the first \$10,500,000, plus \$750,000 of the remaining \$1,500,000). This \$150,000 reduction results from the selling venturer's now receiving 20% instead of 50% of \$500,000 of the \$12,000,000 buy/sell amount.

If the \$12,000,000 buy/sell amount were increased by the \$500,000 contribution, then the purchase price for the 20% venturer's interest would be increased by \$100,000 to \$3,100,000 (and this increase basically would constitute a recoupment of the 20% venturer's additional \$100,000 investment under the above example).

C. Distributions

How should the venturers treat distributions during the period between the exercising of the buy/sell and the closing of the buy/sell? As with contributions, the distributions may be addressed in multiple ways.

1. *Prohibiting Distributions*

Some venture agreements do not permit distributions during this interim period. However, the parties may have better uses for the funds than to leave them in reserve in the venture. Often the parties will want to find a way to get the cash as soon as possible by making a current distribution and an appropriate adjustment at closing. Moreover, withholding distributions of operating cash flow may not be fair to the selling venturer unless the buy/sell amount is increased to reflect the corresponding increase in reserves.

2. *Decreasing Buy/Sell Amount and Redoing Calculations*

One may argue that any distribution reduces the assets of the venture—and consequently their value—and therefore should reduce the buy/sell amount accordingly. This argument may make sense if the proceeds are capital in nature (for example, sale proceeds), but venturers should be careful to avoid double counting of financing proceed distributions if the buy/sell price is determined after payment of all venture liabilities, including the debt. A similar argument applies to reserves existing at the time the buy/sell is exercised. Consequently, some buy/sell provisions reduce the buy/sell amount by the amount of any distributions of capital proceeds or pre-existing reserves, to the extent not already taken into account, and redo the price calculation.

Example 7. Assume the same facts in Example 3,⁴⁹ but that a sale of an out-parcel occurs, which results in the distribution of \$500,000 of net sale

⁴⁹ See *id.*

proceeds (\$400,000 to the 80% venturer and \$100,000 to the 20% venturer). Obviously, the out-parcel was part of the assets of the venture. If the venture retains the distributions, then no problem arises. However, if the distributions are given to the venturers, then the assets in which the purchasing venturer is acquiring an interest are no longer the same. If the \$12,000,000 buy/sell amount were decreased by the \$500,000 distributions, then the 20% venturer would receive \$2,900,000 (\$1,900,000 of the first \$9,500,000 plus \$1,000,000 of the remaining \$2,000,000). Thus, the purchase price for the 20% venturer's interest would be decreased by \$100,000, which is the same amount it received from the sale of the out-parcel.

3. *Redoing Calculation at Closing*

Even if no adjustment to the buy/sell amount occurs, some agreements provide for a recalculation of the buy/sell price at closing.

Example 8. Assume the facts in Example 3,⁵⁰ but that a \$500,000 interim distribution of operating cash flow occurs (\$400,000 to the 80% venturer and \$100,000 to the 20% venturer). If the price calculation were made again at closing without decreasing the buy/sell amount, the price for the 20% venturer's interest would be \$3,150,000 (\$1,900,000 of the first \$9,500,000, plus \$1,250,000 of the remaining \$2,500,000). This \$150,000 increase occurs because the selling venturer now would be receiving 50%, instead of 20%, of \$500,000 of the \$12,000,000 buy/sell amount.

D. Exclusive/Non-Compete

What if the venturers have an exclusive or non-compete agreement under which a venturer may not compete or must give the other venturer an opportunity to participate in certain real estate activities? If the purpose of the buy/sell is to end the relationship, then any further opportunity to participate together may no longer make sense. But what if the buy/sell does not close? Should the right to participate terminate only when the buy/sell closes? The same logic may not apply in connection with a non-compete agreement, especially in connection with a new project in which the venturers agree to a non-compete covenant to give the project a chance to establish itself. Indeed, there may be circumstances in which the parties may need the non-compete agreement even more when they part ways.⁵¹

⁵⁰ See *id.*

⁵¹ See 2 ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 7.12(b)(2) (Supp. 2001) (discussing the enforceability of a non-compete after a partner withdraws from a partnership).

VII. REMEDIES

What happens if a venturer defaults under the buy/sell provisions?

A. Defaulting Purchaser

If the purchasing venturer defaults and the buy/sell required a deposit, the deposit may be liquidated damages. However, this does not accomplish the venturers' goal of parting ways. Some venture agreements provide that default under the buy/sell may result in a loss of voting rights so that a defaulting venturer can become as distant as possible without actually withdrawing and without requiring an actual buyout. Venture agreements can also provide that the selling venturer may purchase the defaulting venturer's interest at a discount. If the agreement provides for a discount, any liquidated damage provision should account for the discount, and the parties should be aware that the "penalty" may not be enforced in bankruptcy, especially when the buy/sell is triggered by the selling venturer's bankruptcy.⁵² Perhaps retaining a reasonable deposit as liquidated damages and then purchasing at par is safer, but this may not work well if the buy/sell price is inflated. Finally, a selling venturer may want to provide expressly for a right to specifically enforce the agreement.

B. Defaulting Seller

Buy/sells rarely specify or exclude any particular remedies for a selling venturer's default. As with a defaulting purchaser, the defaulting seller's voting rights may be lost. The purchasing venturer may want to state expressly that it has all its rights and remedies at law, including the right to damages and specific performance.⁵³

VIII. CONFLICTS WITH OTHER OBLIGATIONS

The buy/sell should not be analyzed in isolation. Many other contractual obligations often affect or are affected by the buy/sell.

⁵² See *Manning v. Nuthatch Hill Assocs. (In re Manning)*, 831 F.2d 205, 211 (10th Cir. 1987) ("[A] 25% discount imposed [in a buy-out of a bankrupt partner] would seem to effect at least a 'modification' of the debtor's property of the estate, which is illegal under both [Bankruptcy Code, sections 541(c) and 363 (l), 11 U.S.C.A. §§ 541(c), 363(l) (Supp. 1987)] . . . [or] might . . . constitute, in effect, unreasonable liquidated damages. . .").

⁵³ For a discussion of specific performance issues under state law and bankruptcy law, see Leon, *supra* note 38.

A. Venture Contracts with Third Parties

What if the venture is subject to third-party agreements (such as a ground lease or loan documents) that do not permit a buy/sell? Ensuring that transfers between venturers (and more specifically, transfers under the buy/sell) do not result in an acceleration of any venture financing, termination, or breach of any agreement of the venture with a third party is important. A lender commonly will insist that the controlling venturer maintain control of the venture. In such circumstances, the venturers should attempt to get the lender to agree not to unreasonably withhold its consent to a substitute so that a sale by the controlling venturer is possible. Otherwise, the buy/sell may solve one problem only to create another.

B. Internal Organizational Documents

There may be issues even within the internal organizational documents of the venturers. For example, if one of the venturers is a closed-end fund, this venturer may not be able to make capital calls to fund a purchase under a buy/sell after a certain point in time. The parties should consider whether they can resolve this by allowing an assignment of the right to purchase under the buy/sell and whether the agreements of the venture with third parties will permit that assignment, as described above. For example, in tiered ventures in which a venturer itself is a venture between different organizations, does the agreement for that internal venture provide for a mechanism to allow that venturer to reach a timely decision as to whether to trigger a buy/sell or respond to a buy/sell election in the operating venture and avoid losing the buy/sell right or being deemed to have elected to sell rather than purchase?

C. Other Terms of Venture Agreement

A venture agreement commonly will have multiple exit strategies. Are the terms of the buy/sell consistent with the provisions governing those other exit strategies? For example, if the venture agreement has a unilateral right to cause a sale subject to a ROFO/ROFR, will a venturer be able to trigger the buy/sell while the unilateral sale right is being exercised?

IX. MULTI-ASSET AND MULTI-PARTY ISSUES

The buy/sell becomes even more complicated when multiple assets or more than two venturers are involved.

A. Multi-Asset Transactions

In a multi-asset transaction, the parties must decide whether the buy/sell

should apply on an asset-by-asset basis or to the venture as a whole. If the purpose of the buy/sell is to end the relationship, then the buy/sell should be done on an all-or-nothing basis. This may not be the case in every situation, such as a venture to make relatively passive joint investments—that do not involve much interaction between the venturers or competitive projects—in which the venturers simply may have different desired holding periods. However, in any such circumstances, the buy/sell may not be the best choice and the parties should consider a put/call or unilateral sale rights subject to a ROFO/ROFR. If a buy/sell is selected, the mechanics of the buy/sell may get complicated.

1. Sale of Asset vs. Interest

If the buy/sell is done on an asset-by-asset basis, the buy/sell provisions often will provide that the purchasing venturer purchase the subject asset from the venture. However, as discussed previously, many disadvantages are associated with the sale of the asset under the buy/sell as opposed to an interest in the venture. If a venture-interest sale is desired, how does one segregate the selling venturer's interest in the particular asset in question? One potential solution is to spin-off the asset into a parallel (sister) venture and then sell the selling venturer's interest in that parallel venture. However, this approach may be analyzed as a step transaction—in relation to the income tax, transfer tax and reassessment that might result. Another possibility, which may be more straightforward, is to distribute an undivided interest in the asset to each of the venturers and have the selling venturer sell its undivided interest in the asset to the purchasing venturer.

2. Pooling of Distributions

Many multi-asset ventures contemplate a pooling of distributions. For example, the venturers may be entitled to recoup their capital from all assets and receive a minimum return on all capital before any disproportionate promotional distributions are made. The parties should consider whether these aggregate distribution provisions should take into account each sale under the buy/sell, as though the hypothetical distributions actually had taken place. The same analysis may apply to a clawback—under which prior promotional distributions are to be returned to ensure that future distributions are sufficient to recoup future capital investments and the minimum return on those investments.

B. Multi-Party Transactions

What if more than two venturers are involved in the venture? Some-

times the venturers can be separated into two groups that act in unison for purposes of the buy/sell. When this is not possible, the agreement may provide that venturers treat everyone other than the initiating venturer as part of the same group for purposes of the buy/sell. Allowing one or more venturers to opt out of the process is also possible. In any case, if multiple venturers are on the same side (or venturers that do not participate), appropriate modifications to the buy/sell provision should be made. Among other matters, the venturers should consider:

1. Whether there should be several, joint, or joint and several liability for any venturers acting in unison;
2. Whether there should be a partial interest discount if two or more venturers remain after the buy/sell (for example, running 95% of the buy/sell amount through the distributions waterfall to determine the purchase price) because only a partial interest is being acquired and (unlike the two-venturer scenario considered elsewhere in this Article) the purchasing venturer will not be acquiring 100% of the venture; and
3. How service agreements between the venture and the selling venturer or its affiliates will be replaced.

X. STATUTORY FRAMEWORK

Keeping in mind how the applicable LLC or partnership statutes may affect the buy/sell is important. Although some statutory provisions are sacrosanct, most of these statutes create default rules that may be modified by the venture agreement.⁵⁴ To the extent permissible, the venturers should draft the buy/sell to avoid a result mandated by statute that is inconsistent with the expectations of the venturers.

As a sampling of the interplay between the applicable statutes and a buy/sell, the following discussion will consider:

1. The need to determine which statutes apply;
2. Whether the buy/sell inadvertently could result in a dissolution or loss of the venture;
3. Whether the buy/sell will trump statutory buy/out provisions;

⁵⁴ See, e.g., RUPA § 103, 6 pt. 1 U.L.A. 73 (2001); REVISED UNIF. LTD. P'SHIP ACT § 110, 6A U.L.A. 23 (2003) [hereinafter "RE-RULPA"]; UNIF. LTD. LIAB. CO. ACT § 103, 6A U.L.A. 567 (2003) [hereinafter "ULLCA"]; DRUPA § 15-103 (Supp. 2002); DRULPA §§ 17-403(b), -1101 (Supp. 2002); DLLCA § 18-1101 (Supp. 2002); 2 BROMBERG & RIBSTEIN, *supra* note 51, § 16.01(c) n.3 (providing a discussion of the Uniform Limited Partnership Act).

4. Whether the buy/sell will override fiduciary and good faith duties;
5. Whether the buy/sell will survive a competing dissolution; and
6. A listing of some other topics in which these statutes may be relevant.

As a preliminary matter, establishing the governing statutory framework is important. For example, if the venture is conducting business in a state other than the state of formation, the laws of both states should be checked. The laws often do not conflict, because many, if not most, state statutes provide that the laws of the state of formation govern the internal affairs of a foreign venture.⁵⁵ However, there may be exceptions. For example, California adopts such a rule for limited partnerships and LLCs, but applies some of its own law for information and inspection rights if more than twenty-five percent of the limited partners or member voting interests reside in California.⁵⁶ Thus, when evaluating a buy/sell under a Delaware LLC formed by California members to own and operate a real estate project in California, both the Delaware LLC statute and California's information and inspection statute⁵⁷ would be relevant. To complicate matters further, RUPA section 106(a) is a default rule that imposes the law of the jurisdiction in which a partnership (other than a limited liability partnership) has its chief executive office (as to the relations between the partners);⁵⁸ and DRUPA section 15-106 is a default rule that imposes the law of the jurisdiction governing the partnership agreement of a partnership (other than a limited liability partnership).

A. Losing the Venture

Could the operation of the buy/sell under the statutory framework inadvertently impede the purchasing venturer's ability to continue the venture? It might.

1. *Causing a Dissolution*

The buy/sell results in a change in the composition of the venturers when the selling venturer is out of the picture. Under an aggregate theory, a new venture is created. The Uniform Partnership Act ("UPA") adopts the

⁵⁵ See, e.g., UNIF. LTD. P'SHIP ACT § 901 (amended 1985), 6A U.L.A. 483 (2003) [hereinafter "RULPA"]; ULLCA § 1001(a), 6A U.L.A. 638 (2003); DRULPA § 17-901; DLLCA § 18-901.

⁵⁶ See CAL. CORP. CODE §§ 15691, 15694, 17450, 17453 (West 1990).

⁵⁷ See *id.* § 17106.

⁵⁸ See 2 BROMBERG & RIBSTEIN, *supra* note 51, § 1.04(d).

aggregate theory, under which this change constitutes a dissolution of the partnership.⁵⁹ Even if the remaining partners continue the business of the partnership, a technical dissolution and the creation of a new entity under the aggregate theory of partnership may have adverse consequences.⁶⁰ Fortunately, most partnerships and LLC statutes today adopt an entity theory and generally provide that the mere departure of a venturer (excluding a partner in an at-will partnership) will not result in the dissolution of the venture, or, if it does, a way to avoid the dissolution is possible.⁶¹

2. *Eliminating the Venture*

Continuing the venture after the buy/sell is possible. Appropriate provisions should be included in the venture agreement, and other steps should be taken to ensure this result. If these steps are not taken, then the buy/sell transfer might not result merely in a dissolution. It might result in the elimination of the venture itself. For example, if the venture is a partnership and the selling partner sells to the only remaining partner (so that, after the buy/sell, there is only one partner), then the partnership may cease to exist because a partnership must have two partners.⁶²

The consequences of losing the venture could be disastrous and may include, for example, a breach of a venture contract, acceleration of a partnership loan, or even the loss of an important contract or license. Although similar to the problems posed by a technical dissolution under the aggregate theory of partnership under the UPA, upon the departure of a partner (as discussed above), the shift to the entity theory does not solve this issue.

3. *Statutory Protections*

Fortunately, some of the statutes provide for a means to salvage the venture. For example, although a limited partnership must have at least one general partner and at least one limited partner under RULPA, RE-RULPA, and DRULPA, a limited partnership is not dissolved under RULPA, RE-RULPA, or DRULPA upon the departure of the last general partner or

⁵⁹ See UNIF. P'SHIP ACT § 29, 6 pt. 2 U.L.A. 349 (2001) [hereinafter "UPA"].

⁶⁰ See, e.g., *Fairway*, 621 F. Supp. at 120 (discussing a situation in which a partnership lost its title insurance).

⁶¹ See RUPA § 801, 6 pt. 1 U.L.A. 189 (2001); RULPA § 801(4) (amended 1985), 6A U.L.A. 462 (2003); RE-RULPA § 801(3), (4), 6A U.L.A. 84 (2003); ULLCA § 801, 6A U.L.A. 619 (2003); DRUPA § 15-801(2) (Supp. 2002); DRULPA § 17-801(3)-(4) (Supp. 2002); DLLCA § 18-801(a)(4), (b) (Supp. 2002).

⁶² See, e.g., RUPA § 101(6), 6 pt. 1 U.L.A. 71 (2001). As a result, the partnership may become a sole proprietorship. See *id.* § 302(d) cmt. 6 (2001).

limited partner if a new one is admitted in accordance with certain statutory procedures.⁶³

4. *Drafting Protections*

Practically addressing the problem of preserving a partnership by structuring the buy/sell so the purchasing partner may assign its rights to purchase to an affiliate who will be admitted to the partnership—immediately before the closing of the buy/sell, if required—is advisable. Further, the partnership agreement should contain the relatively standard provisions stating that the departure of a partner—except in specific situations that the partners choose—will not result in a dissolution of the partnership and that the business of the partnership will continue. If all these provisions are included and any necessary assignments and admissions are accomplished so at least two partners are always in a partnership and at least one general partner and one limited partner are always in a limited partnership, then the buy/sell should not result in a dissolution or elimination of a partnership.

If the venture is an LLC and the standard continuation provisions are included, then an issue likely will not arise because “[t]he vast majority of statutes now explicitly allow LLCs to have only one member.”⁶⁴

B. Statutory Buyout

When a venturer departs from a venture, the venturer may be entitled to a statutory buyout under a statutory buyout formula.⁶⁵ Will the consensual buy/sell provision override the statutory buyout formula? Generally, it should.

Although neither the Uniform Acts nor the Delaware statutes identify the statutory buyout formula as a non-waivable provision, the comments to RUPA section 701,⁶⁶ and to a lesser extent, the comments to ULLCA

⁶³ RULPA §§ 101(7), 801(4) (amended 1985), 6A U.L.A. 223, 462 (2003); RE-RULPA §§ 102(11), 801(3)(B), 801(4), 6A U.L.A. 13, 84 (2003); DRULPA §§ 17-101(9), -801(3), -801(4).

⁶⁴ See LARRY E. RIBSTEIN & ROBERT R. KEATINGE, 1 RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES §§ 1.3, 4.3, app. 4-1 at 4-52, 4-53 (2003); see also ULLCA § 202(a), 6A U.L.A. 578 (2003); DLLCA § 18-101(6).

⁶⁵ RUPA § 701, 6 pt. 1 U.L.A. 175 (2001); RULPA § 604 (amended 1985), 6A U.L.A. 433 (2003); ULLCA § 701, 6A U.L.A. 553 (2003); DRULPA § 17-604; DLLCA § 18-604. RE-RULPA does not provide for a statutory buy-out.

⁶⁶ RUPA § 701 cmts. 2, 3, 6 pt. 1 U.L.A. 176-77 (2001) (“The buyout is mandatory” and “providing for a complete forfeiture would probably not be enforceable. See section 104(a).”). RUPA section 104(a) incorporates “principles of law and equity” unless “dis-

section 701⁶⁷ suggest that other rules of law and equity might come into play under RUPA or ULLCA in determining whether a buyout is enforceable. As one commentator has concluded about RUPA, "[T]he parties may or may not be able to restrict the buyout by contracting for liquidated damages, a low buyout price, or a non-competition agreement."⁶⁸ The confusion created by RUPA and ULLCA comments may raise some doubt, when those statutes are relevant, about the enforceability of a buy/sell provision if it otherwise would operate in a grossly unfair manner.

C. Fiduciary and Good Faith Duties

Could the buy/sell, or the manner in which the buy/sell is implemented, run afoul of a fiduciary duty or the duty of good faith and fair dealing?

1. Examples

For example, if a venture is subject to a third-party loan that is in default and only one of the venturers has the resources to pay off the loan, then that venturer may be precluded from acquiring the debt and engineering a takeover of the venture through the buy/sell under a threat of foreclosure.⁶⁹ Similarly, a venturer with a discretionary right to make capital calls may not be able to make an excessive or premature capital call to deplete the resources of the other venturer to take over the venture through the buy/sell process. But this may be hard to prove.⁷⁰

2. Minimum Standards

Many partnership and LLC statutes expressly provide for fiduciary and good faith duties.⁷¹ The venturers can provide stricter or more lenient

placed by particular provisions of this [Act]." RUPA § 104, 6 pt. 1 U.L.A. 78 (2001).

⁶⁷ ULLCA § 701 cmt., 6A U.L.A. 614 (2003) ("[A] complete forfeiture of the purchase right may be unenforceable. . . . See Section 104(a).").

⁶⁸ 2 BROMBERG & RIBSTEIN, *supra* note 51, § 7.13(i)(2).

⁶⁹ See *BT-I v. Equitable Life Assurance Soc'y of the United States*, 89 Cal. Rptr. 2d 811 (Ct. App. 1999) (applying the California Revised Limited Partnership Act, CAL. CORP. CODE §§ 15611-15723 (West 1990), to a limited partnership agreement that was not governed by the California Revised Partnership Act, CAL. CORP. CODE §§ 16100-16962 (West 1990), and holding that the purchase and foreclosure of partnership debt constituted a breach of fiduciary duty).

⁷⁰ See *Walter*, 985 F.2d at 1245; *Hindman v. Salt Pond Assocs.*, No. 1536, 1992 Del. Ch. LEXIS 265 (1992), *aff'd*, 633 A.2d 370 (Del. 1993).

⁷¹ See, e.g., RUPA § 404, 6 pt. 1 U.L.A. 143 (2001); RE-RULPA §§ 305, 408, 6A U.L.A. 51, 62 (2003); ULLCA § 409, 6A U.L.A. 600 (2003); DRUPA § 15-404 (Supp. 2002).

standards in the venture agreement. However, some statutes impose minimum fiduciary and good faith standards that venturers cannot waive in the venture agreement. For example, under RUPA, the partnership agreement cannot eliminate the duty of loyalty (although RUPA permits certain limitations), cannot unreasonably reduce the duty of care, and cannot eliminate (but may limit in certain ways that are “not manifestly unreasonable”⁷²) the duty of good faith and fair dealing, which is not characterized as a fiduciary duty.⁷³ The *Equitable* court asserted that “the fact that the act allows the parties to structure many aspects of their relationship is not a license to freely engage in self-dealing—it remains our responsibility to delimit the outer boundaries of permissible conduct by a fiduciary.”⁷⁴ This admonition, although made with reference to a California limited partnership that elected not to apply CRPA, instead of the California Partnership Act, may still reflect judicial sentiment when it comes to broad-brush attempts to avoid fiduciary duties under uniform statutes.⁷⁵

3. *Using Delaware Law to Eliminate Duties?*

But what about Delaware? In recent years, there has been much confusion about the extent to which one can contract around fiduciary and other duties by using certain Delaware entities.⁷⁶ Some practitioners assumed that they could contract completely around such duties. They took comfort from certain Delaware opinions that seemed to support this view:⁷⁷

⁷² RUPA § 103(b)(3)(i), 6 pt. 1 U.L.A. 73 (2001).

⁷³ See RUPA §§ 103(b)(3)-(5), 6 pt. 1 U.L.A. 73 (2001); see also ULLCA §§ 103(b)(2)-(4), 6A U.L.A. 567-68 (2003) for similar provisions.

⁷⁴ 89 Cal. Rptr. 2d at 817-18.

⁷⁵ See *id.* But see CAL. CORP. CODE § 16404(e) (West Supp. 2004) (“A partner does not violate a duty . . . merely because the partner’s conduct furthers the partner’s own interest.”); *Jones v. Wagner*, 108 Cal. Rptr. 2d 669, 674 (Ct. App. 2001) (allowing one of two couples in a partnership to purchase the partnership property at a foreclosure caused by the other couple’s breach of its agreement to make the mortgage payments); Edward Gartenberg & Tiffany King, *Fiduciary Duties in Partnerships and Limited Liability Companies under California Law*, CAL. BUS. L. PRAC., Fall 2003, at 93.

⁷⁶ Before August 1, 2004, DRULPA § 17-1101(d) (Supp. 2002) provided that “duties (including fiduciary duties) and liabilities . . . may be expanded or restricted by provisions in a partnership agreement.” See DLLCA § 18-1101(c) (Supp. 2002) for similar provisions prior to August 1, 2004.

⁷⁷ See Kenneth M. Jacobson, *Fiduciary Duty Considerations in Choice of Entity*, 36 REAL PROP. PROB. & TR. J. 1, 13, 17, 19 (2001) (discussing, among other matters, the elimination of fiduciary duties under DRUPA); Joseph L. Lemon, Jr., *Note, Just How Limited is that Liability?: The Enforceability of Indemnification, Advancement, and Fiduciary Duty Modification Provisions in LP, LLP and LLC Agreements in Delaware Law*,

1. “[P]rinciples of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions to do so plain. . . . § 17-1101(d) . . . [provides an] apparently broad license to enhance, reform or even eliminate fiduciary duty protections,”⁷⁸ and
2. “§ 17-1101(d)(2) of DRULPA expressly authorizes the elimination . . . of . . . fiduciary duties in the written agreement governing the limited partnership.”⁷⁹

In October 2002, the Delaware Supreme Court put the world on notice that this was a dangerous assumption. The court went out of its way to “raise a note of concern and caution” that the “dubious dictum” in the *Gotham Partners* memorandum opinion in 2002 (which was not appealed), regarding elimination of fiduciary duties, might be “misinterpreted in future cases as a correct rule of law.”⁸⁰ As pointed out by the Delaware Supreme Court, the statute in question did not expressly allow the elimination of fiduciary duties. The Delaware legislature then responded by amending the Delaware statutes, effective August 1, 2004, to state that duties, including fiduciary duties, may be eliminated, but the implied contractual covenant of good faith and fair dealing may not be eliminated.⁸¹ How many venturers will be willing to eliminate fiduciary duties entirely, and when they do, will the elimination be drafted effectively?⁸²

8 STAN. J.L. BUS. & FIN. 289 (2003) (discussing default fiduciary duties and modification by contract).

⁷⁸ *Sonet v. Plum Creek Timber Co.*, 722 A.2d 319, 322-23 (Del. Ch. 1998).

⁷⁹ *Gotham Partners v. Hallwood Realty Partners*, Civ. A. No. 15754, 2000 Del. Ch. LEXIS 146, at *34 (Del. Ch. Sept. 27, 2000) (mem.).

⁸⁰ *Gotham Partners v. Hallwood Realty Partners*, 817 A.2d 160, 167-68 (Del. 2002), *on remand* 855 A.2d 1059 (Del. Ch. 2003), *aff'd* 840 A.2d 641 (Del. 2003) (Table of Decisions Without Published Opinions).

⁸¹ See DRUPA § 15-103(b)(3) (Supp. 2002); DRULPA § 17-1101(d); DLLCA § 18-1101(c); *see also* DRUPA § 15-103(f); DRULPA § 17-1101(f); DLLCA § 18-1101(e) (permitting the limitation or elimination of any and all liabilities for breach of contract and breach of duties, including fiduciary duties, but the venturers “may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing”); Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Covenant of Good Faith and Fair Dealing Under Delaware Law*, PUBOGRAM NEWSLETTER (ABA section of Business Law), Nov. 2004, at 8.

⁸² *See, e.g.*, *Miller v. American Real Estate Partners*, Civ. A. No. 16788, 2001 Del. Ch. LEXIS 116, at *19 (Del. Ch. Sept. 6, 2001) (finding that the provisions of a partnership agreement, apparently intended to give a general partner the right to act in its own self interest (“to consider only such interests . . . as it desires [with] no duty . . . to give any

4. Using Delaware Law to Enforce Specific Requirements

The Delaware default statutes continue to shield venturers from liability for a breach of fiduciary duty when acting in good faith reliance on the provisions of the venture agreement.⁸³ The prior default statutes were not limited to a breach of fiduciary duty. However, according to the courts, they did not permit a good faith breach of an unambiguous provision.⁸⁴ Even a good faith breach of an ambiguous provision may not have been safe under an unreasonable interpretation.⁸⁵ Now, the protection under these default statutes is limited to a breach of fiduciary duty.

Thus, if the buy/sell provisions in the venture agreement allow a specific act, then that act, in and of itself, when taken in good faith reliance on the buy/sell provisions, should not be a basis for liability for a breach of fiduciary duty under the Delaware limited partnership and LLC statutes. Moreover, following express buy/sell provisions should help avoid running afoul of the implied covenant of good faith and fair dealing because “the express terms of the contract override the implied covenant.”⁸⁶

consideration to any interest of . . . the Partnership”) were not sufficiently clear to eliminate fiduciary duties); *see also* Howard W. Lefkowitz, *Now That Delaware Fiduciary Duties Have Been “Clarified,” Is Everything Clear?*, PUBOGRAM NEWSLETTER (ABA Section of Business Law), Nov. 2004, at 20.

⁸³ *See* DRUPA § 15-103(e) (WESTLAW through 2004 legislation); DRULPA § 17-1101(e) (WESTLAW through 2004 legislation); DLLCA § 18-1101(d) WESTLAW through 2004 legislation); *see also* former statutes DRUPA § 15-103(e); DRULPA § 17-1101(d)(1); LLC § 18-1101(c)(1); *United States Cellular Inv. Co. v. Bell Atlantic Mobile Sys., Inc.*, 677 A.2d 497, 504 (Del. 1996).

⁸⁴ *Cont’l. Ins. Co. v. Rutledge & Co.*, 750 A.2d 1219, 1240 (Del. Ch. 2000); *Gotham Partners v. Hallwood Realty Partners*, 795 A.2d 1, 31 (Del. Ch. 2001), *aff’d in part, rev’d in part*, 817 A.2d 160 (Del. 2002).

⁸⁵ *See In re Nantucket Island Assocs. Ltd. P’ship Unitholders Litig.*, Civ. A. No. 17379 NC, 2002 Del. Ch. LEXIS 143, at *13 n.9 (Del. Ch. Dec. 16, 2002); *see also In re Nantucket Island Assocs. Ltd. P’ship Unitholders Litig.*, 810 A.2d 351, 361 (Del. Ch. 2002) (effectively eliminating an ambiguity by interpreting the partnership agreement against the general partner because he drafted the document); *cf. Schafer*, 741 N.E.2d at 175, 176.

⁸⁶ *The Ins. Co. of Pa. v. Pan Am. Energy L.L.C.*, Civ. A. No. 19629 NC, 2003 Del. Ch. LEXIS 29, at *26 n.42 (Del. Ch. Mar. 19, 2003); *Dave Greytak Enters., Inc. v. Mazda Motors of Am., Inc.*, 622 A.2d 14, 23 (Del. Ch. 1992) (“[W]here the subject at issue is expressly covered by the contract, . . . the implied duty to perform in good faith does not come into play.”), *aff’d*, 609 A.2d 668 (Del. 1992) (mem.); *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1143 (Del. 1990) (“Although an implied covenant of good faith and honest conduct exists in every contract, . . . such subjective standards [referring to the plaintiff’s claim that the defendant deliberately invoked the provisions of the agreement to gain an advantage] cannot override the literal terms of an agreement.”) (citations omitted); *cf. VTR, Inc. v. Goodyear Tire & Rubber Co.*, 303 F. Supp. 773, 777 (S.D.N.Y. 1969), *cited in Pan Am.*

Having express and clear buy/sell provisions may be the safest course of action; the failure to do so may be costly. In a recent Delaware case, a capital partner failed to document that the buy/sell and distributions provisions in a portfolio transaction involving multiple partnerships were to be interpreted on an aggregate basis.⁸⁷ In response to a buy/sell notice from the operating partner, the capital partner elected to be a buyer, but only on the basis of an aggregate calculation.⁸⁸ As is common, the relevant buy/sell provisions provided that the failure to elect to buy resulted in a deemed election to sell.⁸⁹ The operating partner took the position that the capital partner's election was ineffective, and therefore, the capital partner became the seller under the buy/sell by default.⁹⁰ The court concluded that the operating partner was correct.⁹¹

5. *Bidding Manipulation and Failure to Disclose*

To put this discussion in context, consider two obvious fiduciary or good faith duty issues that may arise in a buy/sell: (1) manipulation of the bidding process by naming an artificially high or low price, and (2) failure to disclose information regarding the venture's assets, including potential opportunities or risks for development, leases, sales, and other matters that may have an effect on value.

a. *Pricing*

The pricing issue may depend on how the venture agreement is drafted. If the venture agreement expressly permits a buy/sell price that has no relationship to fair market value, then the venture agreement should control. On the other hand, if the venture agreement requires a good faith estimate of value, then intentional manipulation should be a breach. In between these two extremes, the answer may vary.⁹²

Energy, 2003 Del. Ch. LEXIS 29, at *26 n.42 and *in* RESTATEMENT (SECOND) OF CONTRACTS § 205 reporter's note (1981) (stating that "the parties may, by express provisions . . . grant the right to engage in the very acts and conduct which would otherwise have been forbidden by an implied covenant of good faith and fair dealing"); *see also* Altman & Raju, *supra* note 81, at 12-13.

⁸⁷ *See* PAMI-LEMB I Inc. v. EMB-NHC, L.L.C., 857 A.2d 998 (Del. Ch. 2004).

⁸⁸ *Id.* at 1001.

⁸⁹ *Id.* at 1015.

⁹⁰ *Id.* at 1001.

⁹¹ *Id.* at 1013-14.

⁹² *But see* Schafer, 741 N.E.2d at 175, 176.

b. Disclosures

Disclosure issues tend to be more problematic. First, a venture agreement that permits complete non-disclosure is unusual. Instead, an obligation to disclose may be in the venture agreement or implied by statute.⁹³ Even if the venture agreement is silent and no specific statutory disclosure obligation applies, good faith disclosure obligations may be consistent with the venture agreement.⁹⁴ Competing confidentiality concerns can make disclosure issues even trickier. For example, imagine a venture between two primary venturers and a third passive venturer who has a small interest but has many competing projects in the area. Under these facts, disclosing venture prospects to the passive venturer may not be in the venture's best interests. Fortunately, the Delaware statutes may allow the venture to keep such information confidential from the passive venturer for a reasonable period of time.⁹⁵ How does this work when a buy/sell is triggered and the disclosure of this information might harm the venture if the passive venturer does not acquire the interests of the other two venturers? Will the passive venturer be at a disadvantage under the buy/sell without this information?

6. Suggested Approach

In sum, having a clear agreement that allows a venturer to exercise its contemplated buy/sell rights without being challenged is helpful, but recognizing that there may be limits is also important. This author believes that life is too short, and the real estate industry is too small, for what likely are to be perceived as deceitful or underhanded tactics in a joint venture. Taking the high road in situations that are morally questionable may not only avoid testing the limits of the law (in what may turn out to be protracted and distracting legal battles), but it may also establish a good reputation that, in the long run, proves to be more profitable than the potential gains from taking unfair advantage of a venturer in a single transaction.

D. Competing Dissolution

Will the buy/sell survive a dissolution? The answer may depend on the facts and circumstances.

⁹³ See, e.g., RUPA § 403(c)(1), 6 pt. 1 U.L.A. 140 (2001); ULLCA § 408(b)(1), 6A U.L.A. 599 (2003).

⁹⁴ See, e.g., *R.S.M. Inc. v. Alliance Capital Mgmt. Holdings, L.P.*, 790 A.2d 478, 499 n.31 (Del. Ch. 2001).

⁹⁵ See DRUPA § 15-403(b) (Supp. 2002); DRULPA § 17-305(b) (Supp. 2002); DLLCA § 18-305(c) (Supp. 2002).

1. *Buy/Sell Before Dissolution*

If the buy/sell is initiated, one of the venturers might initiate a dissolution of the venture to short-circuit the buy/sell. The unhappy venturer may think that dissolution and the winding up that might follow would better serve its interests. The venture agreement may specify that dissolution is not available while the buy/sell is in process. However, certain dissolution rights are not waivable.⁹⁶

For example, if a venturer initiates the buy/sell, but has repeatedly taken action (such as refusing to fund required capital contributions or refusing to perform required development obligations) that has made carrying on the venture business in accordance with the venture agreement not reasonably practicable, then the other venturer may be able to compel a dissolution.⁹⁷ Thus, if a capital partner starves the venture for cash in violation of the partnership agreement and then triggers the buy/sell with a low-ball price when it knows the other partner will be forced to sell (because of a lack of capital), one of the available protections to the other partner may be judicial dissolution.⁹⁸ Similarly, if a developer partner refuses to perform the services required under the partnership agreement to create the anticipated value and then tries to capture most of the future value for itself by triggering the buy/sell at a price that is higher than the value the other partner can create but much less than the value the developer partner can create, perhaps judicial dissolution will be available to the other partner.⁹⁹ If judicial dissolution is available, will a venturer be able to enjoin the buy/sell? If not, will the venturer get the protection the dissolution is intended to provide?

But what happens when the venturers simply have a disagreement and they are so much at odds that carrying on the business is not reasonably practicable, but the venturers have included a buy/sell in their venture agreement to address this situation? Each of the statutes¹⁰⁰ refers to carrying

⁹⁶ See, e.g., RUPA §§ 103(b)(8), 801(4), (5), (6), 6 pt. 1 U.L.A. 74, 189 (2001); RE-RULPA §§ 110(b)(9), 802, 6A U.L.A. 24 (2003); ULLCA §§ 103(b)(6), 801(3), (4), 6A U.L.A. 568, 619 (2003); DRUPA §§ 15-103(b)(6), 15-801(4), (5), (6).

⁹⁷ See, e.g., RUPA § 801(5)(iii), 6 pt. 1 U.L.A. 189 (2001); RULPA § 802 (amended 1985), 6A U.L.A. 469 (2003); RE-RULPA § 802, 6A U.L.A. 85 (2003); ULLCA § 801(4)(iii), 6A U.L.A. 619 (2003); DRUPA § 15-801(5); DRULPA § 17-801(6); DLLCA § 18-801(a)(5); cf. 2 BROMBERG & RIBSTEIN, *supra* note 51, § 7.06(c)(1), nn. 42 & 46, § 7.06(e).

⁹⁸ See 2 BROMBERG & RIBSTEIN, *supra* note 51, § 7.06(c)(1).

⁹⁹ See *id.*

¹⁰⁰ See statutes cited *supra* note 97.

on “the partnership business in conformity with the [venture] agreement.”¹⁰¹ As noted by one commentator about RUPA, “[T]he reference to the partnership agreement confirms that the court should order dissolution only when this would effectuate, rather than frustrate, the partnership agreement.”¹⁰² Thus, under these circumstances, when the buy/sell is designed as the mechanism to resolve such disagreements, the author believes a court should enforce the buy/sell and not allow dissolution so that the business may continue in the manner contemplated by the partnership agreement.

As another example of when judicial dissolution may be available, under ULLCA, if the member initiating the buy/sell “ha[s] acted, [is] acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the [other member],”¹⁰³ then the other member’s attempt to compel dissolution may prevail.

2. *Buy/Sell After Dissolution*

What if the dissolution already has commenced and one of the venturers wants to initiate the buy/sell? Will the dissolution trump the buy/sell or should the buy/sell still be available during the winding-up period? The venture agreement may specify that the buy/sell is not available during the dissolution process. But what if it does not? If the buy/sell is allowed to commence, is it merely a race to the finish (with the buy/sell rendered meaningless if the venture is liquidated before the buy/sell is completed)? Should a venturer be able to stop the dissolution?

The buy/sell should not prevent a non-waivable dissolution. Indeed, the order in which the venturer commences the buy/sell and the dissolution may not be relevant if a non-waivable dissolution right exists. However, whether such a right exists is not always clear.

What if the venture agreement provides for a dissolution at the end of the term of a venture, but also could be read to allow for the buy/sell at that time, without expressly stating that the buy/sell may or may not be initiated after the expiration of the term? If the intent is ambiguous, can a responding venturer demand a mandatory dissolution because carrying on the venture business in accordance with the venture agreement is not reasonably practicable? Even if mandatory dissolution is not available on such grounds, it

¹⁰¹ RUPA § 801(5)(iii), 6 pt. I U.L.A. 189 (2001); RULPA § 802 (amended 1985), 6A U.L.A. 469 (2003); RE-RULPA § 802, 6A U.L.A. 85 (2003); ULLCA § 801(4)(iii), 6A U.L.A. 619 (2003); DRUPA § 15-801(5); DRULPA § 17-801(6); DLLCA § 18-801(a)(5).

¹⁰² 2 BROMBERG & RIBSTEIN, *supra* note 51, § 7.06(e).

¹⁰³ ULLCA § 801(4)(v), 6A U.L.A. 619 (2003).

might be available to a transferee (such as a lender who foreclosed upon and acquired a venturer's interest) who does not want the venture to continue past the expiration of the stated venture term.¹⁰⁴

E. Other Matters

Numerous other statutory provisions may be relevant in connection with the buy/sell. Many, if not most, of these provisions should be considered generally in the context of permitted transfers, especially those between venturers, whether under a buy/sell, right of first opportunity, or otherwise. They include:

1. Restrictions on transfers of more than economic interests;¹⁰⁵
2. Filings in connection with a transfer;¹⁰⁶
3. Pre-transfer access of transferor to venture records;¹⁰⁷
4. Post-transfer access of transferor to venture records;¹⁰⁸
5. Pre-transfer authority of transferor;¹⁰⁹

¹⁰⁴ See, e.g., RUPA § 801(6), 6 pt. 1 U.L.A. 189 (2001); DRUPA § 15-801(6)(i). *But see* 2 BROMBERG & RIBSTEIN, *supra* note 51, §§ 7.06(f), 7.11 nn. 6-8 (discussing the possibility that the transferee may be entitled to a buy-out rather than dissolution).

¹⁰⁵ See, e.g., RUPA §§ 502-03, 6 pt. 1 U.L.A. 153 (2001); RULPA §§ 301, 401, 702, 704 (amended 1985), 6A U.L.A. 316, 356, 447, 457 (2003); RE-RULPA §§ 301, 401, 701, 702, 704, 6A U.L.A. 45, 54, 80, 83 (2003); ULLCA §§ 501-03, 6A U.L.A. 604-06 (2003); DRUPA §§ 15-502, -503; DRULPA §§ 17-301, -401, -702, -704, -705; DLLCA §§ 18-702, -704, -705.

¹⁰⁶ See, e.g., RUPA § 704, 6 pt. 1 U.L.A. 186 (2001) (allowing permissive filing of statement of dissociation); RULPA § 202(b) (amended 1985), 6A U.L.A. 278 (2003) (requiring filing of an amendment to the certificate of limited partnership within thirty days after admission or withdrawal of a general partner); RE-RULPA § 202(b), 6A U.L.A. 35 (2003) (requiring filing of an amendment to a certificate of limited partnership promptly after the admission or dissociation of a general partner); ULLCA § 704(a), 6A U.L.A. 618 (2003) (allowing permissive filing of a statement of dissociation); DRUPA § 15-704 (allowing permissive filing of a statement of dissociation); DRULPA § 17-202(c) (requiring filing of an amendment to the certificate of limited partnership within ninety days after the admission or withdrawal of a general partner).

¹⁰⁷ See, e.g., RUPA §§ 103(b)(2), 403(b), (c), 6 pt. 1 U.L.A. 73, 140 (2001); RULPA §§ 105, 305, 403(a) (amended 1985), 6A U.L.A. 250, 349, 365 (2003); RE-RULPA §§ 111, 304, 407, 6A U.L.A. 26, 47, 60 (2003); ULLCA § 408, 6A U.L.A. 599 (2003); DRUPA § 15-403; DRULPA §§ 17-305, -403(a); DLLCA § 18-305.

¹⁰⁸ See, e.g., RUPA §§ 103(b)(2), 403(b), 6 pt. 1 U.L.A. 73, 140 (2001); RULPA § 403(a) (amended 1985), 6A U.L.A. 365 (2003); RE-RULPA §§ 111, 304(d), 407(c), 6A U.L.A. 26, 47, 60 (2003); ULLCA § 408(a), 6A U.L.A. 599 (2003); DRUPA § 15-403(a); DRULPA §§ 17-305, -403(a).

¹⁰⁹ See, e.g., RUPA §§ 301, 303, 401(f), 6 pt. 1 U.L.A. 101, 107, 133 (2001); RULPA § 403(a) (amended 1985), 6A U.L.A. 365 (2003); RE-RULPA §§ 302, 402, 406(a), 6A

6. Post-transfer authority of transferor;¹¹⁰ and
7. Post-transfer venture liability and indemnification of transferor.¹¹¹

Further discussion of these statutory provisions is beyond the scope of this Article.

XI. CONCLUSION AND WORDS OF CAUTION

The buy/sell is a relatively common exit strategy in real estate joint venture transactions. If crafted properly, the buy/sell may provide a way to end the joint venture relationship between the venturers without too much fuss. However, the buy/sell is not always the best approach.

Although it appears on its face to be even-handed, parity does not always exist. For example, if one venturer owns 80% of the venture and the other venturer owns 20%, then vastly different consequences may result, depending on who sells. For example, (1) the price—and any proportionate deposit—may be significantly less when the 20% venturer sells than when the 80% venturer sells, and (2) there may be a reassessment, a Code section 708 tax termination, a transfer tax, or a loan default when the 80% venturer sells that might not occur when the 20% venturer sells.

Even if the venturers each have roughly 50% interests, preferential or subordinated distribution schemes may lead to mischief.¹¹²

A vast disparity in terms of capital resources, tax consequences, or other matters may also make a venturer more likely to buy or sell. Many venturers are concerned that the other venturer might take advantage of this fact. For example, many developers fear that their financial partners will be able to specify a lowball buy/sell amount and force the developer to sell at a discount because the developer does not have access to capital to allow it to purchase. However, many developers do have access to capital, including

U.L.A. 45, 55, 58 (2003); ULLCA §§ 301, 404, 6A U.L.A. 588, 594 (2003); DRUPA §§ 15-301, -303, -401(f); DRULPA § 17-403(a); DLLCA § 18-402.

¹¹⁰ See, e.g., RUPA §§ 303(e), 603(b), 702, 704, 6 pt. 1 U.L.A. 108, 172, 180, 186 (2001); RULPA § 403(a) (amended 1985), 6A U.L.A. 365 (2003); RE-RULPA §§ 103(d)(1), 605(a)(1), 606, 6A U.L.A. 16, 76, 77 (2003); ULLCA §§ 603(b)(1), 703, 6A U.L.A. 612, 617 (2003); DRUPA §§ 15-303(c), -603(b)(1), -704; DRULPA § 17-403(a); DLLCA § 18-402.

¹¹¹ See, e.g., RUPA §§ 401(c), 703, 6 pt. 1 U.L.A. 133, 183 (2001); RULPA § 403(b) (amended 1985), 6A U.L.A. 365 (2003); RE-RULPA § 607, 6A U.L.A. 78 (2003); ULLCA § 303(a), 6A U.L.A. 590 (2003); DRUPA §§ 15-110, -401(c), -701(d), -703; DRULPA §§ 17-108, -403(b); DLLCA §§ 18-108, -303(a).

¹¹² See Example 4, *supra* Part III.E.2.

through other financial partners, and many financial partners are concerned that the developer's expertise and knowledge of the asset may give the developer an unfair advantage. For example, (1) because of its inferior knowledge, the financial partner may have more difficulty pinpointing the value of the venture's assets, and (2) the venture's assets may have less value to the financial partner alone because of the difficulty, time, and cost of getting an equally qualified developer to achieve the value of the project.

Finally, the prospects of cashing out of, or doubling-down on, one's investment—without testing the market—may not be attractive alternatives, especially if a desire to diversify and share risk was part of the motivation to enter into the venture.

As indicated in this Article, there may be solutions (such as blackouts and longer response periods) to some of the issues presented by the buy/sell, but not always. A perfect divorce is not possible, and if the venturers' interests are not aligned, the venturers should understand the potential for disagreement and choose the best exit strategy under the circumstances.

XII. APPENDIX: WHAT'S IN A NAME?

Unfortunately, the term "buy/sell" may have a meaning that is different from the one that is used in this Article. Moreover, the process described in this Article is not always called a buy/sell.

A. Other Meanings of "Buy/Sell"

A buy/sell agreement may refer to almost any agreement to buy and sell.

1. Sale of Interest Upon Certain Events

In the closely-held or professional corporation or family or professional partnership context, especially when the owners are individuals, a "buy/sell" or "buy and sell agreement" frequently refers to the right or obligation of the entity or certain owners to buy another owner's interest upon the occurrence of certain events, usually the death or termination of employment of that owner or the attempt by that owner to transfer his interest to an outsider. Unlike the buy/sell described in this Article, when this buy/sell comes into play, the identity of the seller is not uncertain. The seller is, for example, the party who has died, whose employment has been terminated, or who is trying to dispose of his interest to any outsider. Moreover, the pricing usually is established by formula or appraisal and is not dictated by one of

the parties in the sale. Much has been written about this type of buy/sell.¹¹³

2. *Restrictions on Sale of Interest*

"Buy/sell agreements" have been defined as "contracts by which owners of a business (stockholders or partners) agree to impose certain restrictions on their right to transfer their interests in the business."¹¹⁴ The restrictions are often similar to those described in the preceding paragraph.

3. *Any Internal Sale of Withdrawing Owner's Interest*

Sometimes buy/sell agreements are interpreted in the broadest sense to encompass almost any sale of a withdrawing owner's interest to the venture or another owner of the venture, and sometimes even other exit strategies.¹¹⁵

4. *Sales Not Involving Venture Interests*

A buy/sell agreement may have nothing to do with a venture agreement. For example:

a. *Sale of Construction Loan to Permanent Lender*

It may refer to a tri-party agreement involving a construction lender, a permanent lender, and a borrower in which the permanent lender agrees to purchase the construction lender's loan.¹¹⁶

¹¹³ See generally Anne Kittlker & Steven A. Ruben, *Estate Planning Considerations*, in BUSINESS BUY-SELL AGREEMENTS 33 (Edward D. Giacomini ed., update 2000); Doron M. Tisser, *Corporate Buy-Sell Agreements*, in BUSINESS BUY-SELL AGREEMENTS 121 (Edward D. Giacomini ed., update 2000); Doron M. Tisser, *Partnership Buy-Sell Agreements*, in BUSINESS BUY-SELL AGREEMENTS 201 (Edward D. Giacomini ed., update 2000); JACOB RABKIN & MARK H. JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS §§ 7A.06, 17.30[2] (2003); 1 CALIFORNIA TRANSACTIONS FORMS, BUSINESS TRANSACTIONS §§ 4:1-:105 (1997); 4 CALIFORNIA TRANSACTIONS FORMS, BUSINESS ENTITIES §§ 19:56-:68 (Dec. 1996). But see *id.* § 19:71 (including an optional provision for a buy/sell as used in the body of this Article).

¹¹⁴ Howard M. Zaritsky, *Structuring Buy-Sell Agreements* ¶ 1.01 (2d ed. 2000); see also J. William Callison, *Partnership Law and Practice: General And Limited Partnerships*, § 34.7 (West 2004).

¹¹⁵ See Fredric D. Tannenbaum, *What Every Business Lawyer and Business Owner Should Know About Buy-Sell Agreements (Part 1)*, PRAC. LAW., Oct. 1999, at 55; Fredric D. Tannenbaum, *What Every Business Lawyer and Business Owner Should Know About Buy-Sell Agreements (Part 2)*, PRAC. LAW., Dec. 1999, at 55.

¹¹⁶ MICHAEL MADISON, ET AL., THE LAW OF REAL ESTATE FINANCING § 5.05[15] (2002); 5 STUART M. SAFT, COMMERCIAL REAL ESTATE FORMS § 9.15 (2001).

b. Any Sale

It may also refer to virtually any sale contract.¹¹⁷

B. Other Names for Buy/Sell

To add to the confusion, the buy/sell, as described in this Article, may go by many other names, including the following:

1. "Chinese or Phoenician option,"¹¹⁸
2. "Chinese Wall Clause,"¹¹⁹
3. "'Cut Throat' Provisions,"¹²⁰
4. "Dynamite or Candy Bar Method,"¹²¹
5. "joint venture roulette,"¹²²
6. "Put-call,"¹²³
7. "Russian Roulette,"¹²⁴

¹¹⁷ See, e.g., *In re Shepherd Oil, Inc.*, 118 B.R. 741, 748 (Bankr. D. Ariz. 1990) (referring to "buy/sell transactions" in another case that involved "buying and selling of precious metals"); *Hokama v. E.F. Hutton & Co.*, 566 F. Supp. 636, 641 (C.D. Cal. 1983) ("buy/sell transaction" involving sale of securities); *Illinois Rockford Corp. v. Dickman*, 520 N.E.2d 1184, 1186 (Ill. App. Ct. 1988) ("buy-sell real estate contract"); *Nordwick v. Berg*, 725 P.2d 1195, 1196-98 (Mont. 1986) ("buy/sell" agreement with seller of real estate).

¹¹⁸ Betsy H. Firger, *The Real Estate Partnership in Default: An Institutional Investor's View* in *THE REAL ESTATE PARTNERSHIP IN DEFAULT 1990: UP-FRONT PROTECTIONS—WORKOUTS AND BANKRUPTCY* 31, 41 (PLI Real Estate Law and Practice Course, Handbook Series No. N4-4541, 1990).

¹¹⁹ Zaritsky, *supra* note 114, ¶ 7.09[1].

¹²⁰ Stephen R. Akers & Myron E. Sildon, *A Practical Guide to Buy-Sell Agreements* § 6.02(j) (ALI-ABA 2002).

¹²¹ Tannenbaum (pt. 2), *supra* note 115, at 65.

¹²² Alfred Mudge, *International Joint Ventures: Drafting the Agreements*, 786 PLI/COMM. 23, 49 (1999).

¹²³ HARTZOG & DIGIUSTO, *supra* note 10, §§ 5.135-5.138; Nellis & Murray, *supra* note 26, at 106; Caryl B. Welborn, *The Joint Venture Buy-Sell Provision*, in *THE REAL ESTATE PARTNERSHIP IN DEFAULT 1990: UP-FRONT PROTECTIONS—WORKOUTS AND BANKRUPTCY* 125, 127 (PLI Real Estate Law and Practice Course, Handbook Series No. N4-454 (1990)). However, a "put/call" often, and in the body of this Article, refers instead to an agreement in which the parties know in advance who will be the seller and who will be the buyer, but either the seller may exercise ("the put") or the buyer may exercise ("the call"). See, e.g., 20 JOHN C. ALE, *PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS* § 6.05[4] (Nov. 2000).

¹²⁴ Michael J. Egan, III, *Fundamentals of Joint Ventures*, in *DOING DEALS 1999 UNDERSTANDING THE NUTS AND BOLTS OF TRANSACTIONAL PRACTICE* 357, 382 (PLI Corporate Law and Practice Handbook Series No. B0-006V, 1999); 1 CALIFORNIA TRANSACTIONS FORMS, *supra* note 113, at § 4.17; Zaritsky, *supra* note 114, ¶ 7.09[1];

8. "Shotgun,"¹²⁵
9. "slice-of-the-pie" procedure/clause,¹²⁶
10. "Solomon's option"¹²⁷ or "Solomon's Choice" . . . procedure,¹²⁸
and
11. "Texas Draw."¹²⁹

Andrew H. Levy & Lindsay Barton, *Avoiding Deadlock in Multi-Party Entities Owning Real Estate*, REAL EST. FIN. J., Summer 2003, at 5, 6; Elliot M. Surkin, *How Do I Get Out of Here? Exit Strategies in Closely-Held Real Estate LLC's*, 18 PRAC. REAL EST. LAW., 27, 35 (2002).

¹²⁵ Denn v. Anderson, No. 42954-0-I, 2000 WL 194679, at *1 (Wash.Ct. App. Feb. 14, 2000). (unpublished opinion)

¹²⁶ 1 CALIFORNIA TRANSACTIONS FORMS, BUSINESS TRANSACTIONS, *supra* note 113, at § 4:17; Zarisky, *supra* note 114, at ¶ 7.09[1].

¹²⁷ Egan, *supra* note 124, at 382.

¹²⁸ 1 CALIFORNIA TRANSACTIONS FORMS, BUSINESS TRANSACTIONS, *supra* note 113, at § 4:17.

¹²⁹ See Phillip G. Nichols, *Texas Draws and Self-Inflicted Wounds: Exit Strategies Gone Awry*, COM. INVESTMENT REAL EST. J., Summer 1986, at 6.

