Shoot-Out Clauses in Partnerships and Close Corporations

– An Approach from Comparative Law and Economic Theory –

by

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This article analyses shoot-out clauses as a popular means of resolving deadlocks in two member partnerships or close corporations. It presents the different varieties of shoot-out clauses developed in Anglo-American legal practice that are being increasingly discussed on the European continent. It goes on to look at their advantages and disadvantages by exploring the rich economic literature on partnership dissolution mechanisms in game theory. Finally, it focuses on the permissibility of these clauses and the doubts cast upon them in Germany, Austria, France, England and the United States.

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I. Introduction

Deadlocks are the Achilles' heel of 50:50 partnerships and corporations[1]. Founding partners are therefore advised to take precautions when signing the contract, even if they are not inclined to discuss future points of contention for fear of souring the deal[2]. In Anglo-American contract practice the shoot-out or buy-sell procedure has been developed to deal with potential deadlocks by enabling one of the two shareholders to purchase all the shares[3]. Inclusion of this procedure has become so widespread that it may be perceived as malpractice when legal advisors do not recommend it to company founders[4]. Shoot outs are also beginning to be discussed with increasing frequency in German literature[5] (and elsewhere[6]) and their inclusion is recommended in sample legal forms published to assist in company foundation[7].

1 See Neville, Mette, in Neville/Sorensen (eds.), Company Law and SMEs, 2010, p. 247; for a detailed analysis Knies, Harald, *Das Patt zwischen den Gesellschaftern der zweigliedrigen GmbH*, 2005; Wolfram, Jens, *US-amerikanischer Deadlock und Selbstblockade der GmbH-Organe*, 1999.

2 See also Comino, Stefani/Nicolo, Antonio/Tedeschi, Piero, 'Termination Clauses in Partnerships', *European Economic Review* 54 (2010), 718, 719: "Just as a pre-nuptial agreement, discussing a termination clause when forming the alliance might sour the deal; it might reveal a lack of trust among partners."

3 For English law see Hewitt, Ian, *Hewitt on Joint Ventures*, 5th ed. 2011, marg. no. 10-25 ff.; for US law, Hoberman, Jason, M., 'Practical Considerations for Drafting and Utilizing Deadlock Solutions for Non-Corporate Business Entities', 2001 *Colum. Bus. L. Rev.* 231; Carey, Stevens, A., 'Buy/Sell Agreements in Joint Venture Real Estate Agreements', 39 *Real Prop. Prob. & Tr. J.* 651 (2005).

4 See de Frutos, Maria-Angeles/Kittsteiner, Thomas, 'Efficient Partnership Dissolution under Buy-Sell Clauses', *RAND Journal of Economics* 39 (2008), 184 f.: "Actually, the buy-sell clause is considered to be such an essential part of partnership agreements, that a lawyer who fails to recommend to his clients one could be accused of malpractice."

5 See Fett, Torsten/Spiering, Christoph in Fett/Spiering (eds.), *Handbuch Joint Venture*, 2010, § 7 marg. no. 591 ff.; Schulte, Norbert/Pohl, Dirk, *Joint-Venture-Gesellschaften*, 2nd ed. 2008, marg. no. 766 ff.; Schulte, Norbert/Sieger, Jürgen J., '"Russian Roulette" und "Texan Shoot-Out" – Zur Gestaltung von radikalen Ausstiegsklauseln in Gesellschaftsverträgen von Joint-Venture-Gesellschaften (GmbH und GmbH & Co. KG)', *NZG* 2005, 24; Wälzholz, Eckhard 'Alternative Regelungstypen zum Gesellschafterausschluss – Texan Shoot out, Tag along, Drag along, Russian Roulette, Bieterverfahren' *GmbH-StB* 2007, 84.

6 From a Nordic company law perspective Svante Johansson, 'Voluntary remedies – the agreed solutions to deadlock', in Neville/Sorensen (note 1), p. 295, 301; from a French perspective Paul Le Cannu, Note, *RTDcom* 2007, 169 ff.; from a Swiss law perspective Clopath, Gion, 'Wie können Pattsituationen bei Zweimanngesellschaften behoben werden?', *SJZ* 1993, 157; Crone, Hans Caspar von der, 'Lösung von Pattsituationen bei Zweimanngesellschaften', *SJZ* 1993, 37, 42 ff

7 See Englisch, Lutz/v. Schnurbein, Caspar Freiherr in *Beck'sches Formularbuch GmbH-Recht*, 2010, Sect. C.III.2, marg. no. 39; Heckschen, Heribert in Heckschen, Heribert/

This article will first present the different varieties of "shoot-out" clauses that can be found in legal practice (II). It will also present their advantages and disadvantages including an analysis of the economic literature covering dissolution mechanisms available to partnerships and close corporations[8] (III). The final section will focus on the permissibility of and the doubts cast upon these clauses in partnership and corporation law[9]. Case law on the matter is not yet available in Germany, although it can be found in Austria[10] and the United States[11] (IV).

II. Shoot-out clauses in legal practice

1. Shoot-out procedures: The term and its significance

Shoot-out procedures provide for a smooth and swift end to a partnership by transferring all shares to one shareholder[12]. Although clauses that provide for this procedure are often used in joint venture contracts[13], they are also useful for venture capital contracts[14] and for smaller partnerships. In practice, they are most popular for 50:50 partnerships and close corporations held by two people[15]. Where more than two partners are involved, shoot-out procedures may still be effective where these partners can be separated into two groups,

Heidinger, Andreas, *Die GmbH in der Gestaltungs- und Beratungspraxis*, 2nd ed. 2009, § 4 marg. no. 190 ff.; Schwarz, Henning in Walz, Robert (Ed.), *Formularbuch Außergerichtliche Streitbeilegung*, 2006, § 20 marg. no. 1 ff.

8 See Brooks, Richard/Landeo, Claudia/Spier, Kathryn, 'Trigger Happy or Gun Shy? Dissolving Common-Value Partnerships with Texan Shootouts', *RAND Journal of Economics* 41 (2010), 649; Li, Jianpei/Wolfstetter, Elmar, 'Partnership Dissolution, Complementarity, and Investment Incentives', *Oxford Economic Papers* 62 (2010), 529; Ornelas, Emanuel/Turner, John, L. 'Efficient Dissolution of Partnership and the Structure of Control', *Games and Economic Behaviour* 60 (2007), 187; Turner, John, L. 'Dissolving (In)effective Partnerships', July 2009, ssrn.com/abstract=964035.

9 Casting some doubt on these clauses: Reinhard, Thorsten in Wachter, Thomas (ed.), *Handbuch des Fachanwalts für Handels- und Gesellschaftsrecht*, 2007, Part 2, Ch. 12, marg. no. 76; Stephan, Klaus Dieter, in Schaumburg, Harald (ed.), *Internationale Joint Ventures*, 1999, p. 97, 118.

10 See OGH Wien, judgment dated 20. 4. 2009 – 28 R 53/09h, *GesRZ* 2009, 376 (headnotes only).

11 See for example *Larken Minnesota, Inc. v. Wray*, 881 F. Supp. 1413 (D. Minn. 1995), *affirmed* 89 F.3d 841 (8th Cir. 1996).

12 See also Fett/Spiering (note 5), § 7 marg. no. 591 ff.; Schulte/Sieger, *NZG* 2005, 24, 25; for English law, Hewitt (note 3), marg. no. 10-25 ff.

13 Hewitt (note 3), marg. no. 10-25 ff.; Schulte/Pohl (note 5), marg. no. 766 ff.

14 See Weitnauer, Wolfgang, 'Der Beteiligungsvertrag', *NZG* 2001, 1065, 1072; see also the case example provided in Hobermann (note 3), 231 f.

15 See Wälzholz (note 5), 86.

each with a homogeneous structure[16]. Where this is not the case, the mechanics of the procedure become significantly more complicated[17].

2. *Forms of shoot-out procedures*

Shoot-out clauses exist in different forms, although they are all based on the same uniform structure with the first part defining a trigger or deadlock event[18], and the second detailing the process to be followed once the procedure is triggered. Often these triggers are associated with a deadlock regarding specifically listed matters for resolution (i.e. major decisions)[19]. To prevent the shoot-out procedure being carried out too hastily or without due consideration, legal practitioners recommend including a negotiation[20] or cooling-off period[21] after the initial notice has been given. If the conflict cannot be resolved during this period, the dissolution process is set in motion. For this second phase, the procedure may take one of several forms, with the main difference being the means of settling on a price:

a) *Russian roulette/buy-sell*

The procedure in its basic form is usually known as Russian roulette[22] or a buy-sell[23] procedure[24]. Party A (the party wishing to leave or take over the company) initiates the procedure by making an offer, either (1) to sell all their shares to Party B, or (2) to purchase all of Party B's shares for a specific price. Party B can then freely decide whether to buy or sell[25]. The clause should clearly regulate what happens if Party B does not make a decision within a specified period of time – for example, failure to communicate a decision may

16 See Schwarz (note 7), § 20 marg. no. 20.
17 See also Carey (note 3), 691 f.
18 See Hewitt (note 3), marg. nos. 10-25 and the examples provided in marg. nos. 10-28; see also Carey (note 3), 662 f.
19 See Hoberman (note 3), 244 f.
20 According to a recommendation by Fett/Spiering (note 5), § 7 marg. no. 562; Schwarz (note 7), § 20 marg. no. 23.
21 As recommended by Hoberman (note 3), 244; Schulte/Pohl (note 5), marg. no. 774.
22 See also Fett/Spiering (note 5), § 7 marg. no. 591 ff.; Hewitt (note 3), marg. no. 10-25 ff.; Schulte/Sieger (note 5), 25 ff.; Schulte/Pohl (note 5), marg. no. 769 ff.
23 See Carey (note 3), 651; De Frutos/Kittsteiner (note 4), 184; Hoberman (note 3), 232 f.
24 For a summary of the terms used see Carey (note 3), 708 f. (2005): "Chinese or Phoenician option", "Shotgun", "Solomon's option".
25 For suggested formulations of shoot-out clauses see Hewitt (note 3), Precedent 20 Nr. 1; and Schwarz (note 7), § 20 Mustertext 20.1.

constitute acceptance of the offer. Alternatively, the shoot-out clause may provide for the purchase price to be decreased (for Party A) or increased (for Party B)[26].

b) *Texas shoot-out*

In Texas shoot-outs[27], Party A offers to buy all shares held by Party B for a specific price. Party B can accept this offer, or make an alternative offer to buy Party A's interest for a *higher* price. The same right is then extended to Party A[28]. This process of offer and counter-offer can continue through many 'rounds', with each bid required to exceed the previous highest bid by a specified percentage[29]. Instead of using this bidding process, the parties may agree to submit sealed bids to an independent third party, with the right to purchase going to either the highest sealed bid or the fairest sealed bid (the price closest to the price determined by the appointed third party as being the fair value of the shares)[30].

c) *Sale shoot-out*

The sale shoot-out functions in a similar way to the Texas shoot-out, but in reverse. Party A makes an offer to sell all shares to Party B. Should Party B not accept this offer to buy, Party B is then obliged to sell its shares to Party A for a lower price than that stated in the initial offer[31].

d) *Deterrent approach*

The deterrent approach, not yet well known in Germany, involves setting a procedure in the articles of association that will determine a fair value per share, after notice has been served initiating a shoot out. Based on this price, Party B can then either purchase A's shares at a pre-agreed discount (e.g. 20%) or sell the shares for the same pre-agreed premium. This approach serves to

26 See Fett/Spiering (note 5), § 7 marg. no. 592; Schulte/Pohl (note 5), marg. no. 778; Schulte/Sieger (note 5), 26.

27 Also Fett/Spiering (note 5), § 7 marg. no. 601; Hewitt (note 3), marg. no. 10-29 ff.; Schulte/Sieger, (note 5), 25 ff.

28 For a suggested formulation of such a clause Schwarz (note 7), § 20 Mustertext 20.2.

29 See Hewitt (note 3), marg. no. 10-29.

30 See Fett/Spiering (note 5), § 7 marg. no. 602; Hewitt (note 3), marg. no. 10-29 f.

31 See Hewitt (note 3), marg. no. 10-31.

encourage parties to seek mutually acceptable solutions, and deter them from instigating the procedure too lightly[32].

III. Economic analysis

1. Advantages and disadvantages

One often cited advantage of the shoot-out procedure is that it ensures a high degree of fairness with regard to price; the parties have an incentive to name the fairest offer price possible, due to the danger of themselves having to sell (or buy) at a disproportionately low (high) price[33]. The Higher Court of Appeal in Vienna refers to "checks and balances" in price determination[34]. Judge Easterbrook summarised a decision of the United States Court of Appeals in a very similar vein: "The possibility that the person naming the price can be forced either to buy or sell keeps the first mover honest"[35]. Other voices compare the partition and selection process to the well-known cake-cutting rule: "I cut, you choose"[36]. Still others regard shoot out clauses as a Solomonic solution[37]. The deterrent approach, which uses an independent third party following a pre-agreed process, can also be expected to ensure a fair price. Additionally, the automatic process contained in a shoot-out procedure allows for a quick and clean exit from the company, even where negotiations between the parties have been abandoned[38]. Moreover, the finality threatened by a shoot-out increases pressure on the parties to find an amicable settlement[39].

The first disadvantage of the shoot-out procedure arises from the lack of a predictable outcome. This may lead to undesired results where a partner who has made a conscious decision to leave the company is instead forced to

32 See Hewitt (note 3), marg. no. 10-32; for the German perspective Wälzholz (note 5), 86.

33 See Heckschen (note 7), § 4 marg. no. 190; Hewitt (note 3), marg. no. 10-26; Schulte/Sieger (note 5), 29; for a more cautious review Carey (note 3), 660 "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."

34 Vienna Court of Appeals, Judgement of 20. 4. 2009 – 28 R 53/09h, *GesRZ* 2009, 376 (headnote only).

35 *Valinote v. Ballis*, 295 F.3d 666, 667 (7th Cir. 2000).

36 See Schwarz (note 7), § 20 marg. no. 9; Wälzholz (note 5), at 84; from the economic literature Li/Wolfstetter (note 8), 530.

37 See Johansson (note 6), 301.

38 See Fett/Spiering (note 5), § 7 marg. no. 570; Schwarz (note 7), § 20 marg. no. 11; Wälzholz (note 5), 86.

39 See for example Fett/Spiering (note 5), § 7 marg. no. 597; Schulte/Pohl (note 5), marg. no. 806 ff.; Schwarz (note 7), § 20 marg. no. 13.

become the sole owner of the company as a result of the shoot-out procedure[40]. Problems also arise where one shareholder possesses the business know-how or necessary goodwill for the operation of the company. The absence of this knowledge or connections may have dire consequences for the remaining shareholder[41]. Also not to be ruled out is the potential abuse of the shoot-out procedure by the financially stronger party to force the other party out of the company at an unfair price: where Party A knows Party B cannot afford to make a counter offer and will be forced to sell, the intended disciplinary effect of the procedure is lost[42]. Similar concerns arise where Party A knows that a purchase or sale is not advisable for strategic or tax reasons[43] or that public law limitations exist that may prevent purchase of the company's shares[44].

2. *Efficient or inefficient dissolution mechanism?*

Unnoticed by corporate lawyers, economists have been focussing on shoot-out procedures for some time[45]. Papers have emerged primarily from the field known as mechanism design[46], a branch of game theory, which proposes rules (e.g. contractual clauses or auction processes) aimed at providing efficient results[47]. One pioneering model put forward by McAfee in 1992 comes to the conclusion that buy-sell clauses are ex post inefficient[48], as company shares do not necessarily end up in the hands of the company partner who values

40 See Carey (note 3), p. 661; Hewitt (note 3), marg. no. 10-27.

41 See Hewitt (note 3), marg. no. 10-26; Schulte/Pohl (note 5), marg. no. 811; Schulte/Sieger (note 5), at 30.

42 See Hewitt (note 3) marg. no. 10-26; Hoberman (note 3), 248; Fett/Spiering (note 5), § 7 marg. no. 598, 600; Schulte/Pohl (note 5), marg. no. 810.

43 See Fett/Spiering (note 5), § 7 marg. no. 598.

44 See Hewitt (note 3), marg. no. 10-26: "restraints on foreign ownership in the country of the JVC".

45 See de Frutos/Kittsteiner (note 4), 185: "Buy-sell clauses have also caught the attention of economic theorists."

46 See Athanassoglou, Stergios/Brams, Steven/Sethuraman, Jay, 'A Note on the Inefficiency of Bidding Over the Price of a Share', *Mathematical Social Sciences 60 (2010)*, 191: "The partnership-dissolution problem has a rich history in economic theory and has been extensively studied from the mechanism-design point of view."

47 Generally Towfigh, Emanual V./Petersen, Niels, *Ökonomische Methoden im Recht*, 2010, p. 73 and 86.

48 See McAfee, Preston, 'Amicable Divorce: Dissolving a Partnership with Simple Mechanisms', *Journal of Economic Theory* 56 (1992), 266, 284: "The cake-cutting mechanism has a disappointing performance in this environment, as it fails to reach ex post efficiency."

them most[49]. Instead, he proposes an auction procedure as an efficient means of company dissolution[50]. Subsequent studies have varied the model's assumptions of asymmetrical information and independent valuation[51]. One newly released study suggests that buy-sell clauses can be efficient where the shareholders bid for the right to propose the sale in the form of an auction process as this allows the partner who values the shares the most to buy all the shares[52]. A further study shifts the attention to the relationship between investment and dissolution decisions. Where a dissolution of the company is highly probable, a shareholder may seek to minimise the cost of this dissolution by underinvesting in the company, which in turn, makes dissolution more likely[53]. The reverse also applies; an overinvestment in the company may make dissolution of the company a practical or financial impossibility. Buy-sell clauses, according to that particular study, lead to efficiency losses[54]. According to another model, in some circumstances it is advantageous not to include a termination clause at all, to provide added incentive for the parties to remain together[55].

Additional studies investigate exit clauses from a perspective of fairness, rather than one of efficiency[56]. This is particularly important, as founding parties who anticipate an unfair distribution of assets on dissolution may be unwilling

49 See also Turner (note 8), p. 1 together with note 1: "[The Texas Shootout] is inefficient whenever the proposer's price prompts the chooser to buy when his valuation is not highest, or sell when his valuation is not lowest."; on the meaning of the term "efficiency" in this context de Frutos/Kittsteiner (note 4), 187: "An allocation is said to be efficient if the partner with the highest valuation receives the entire partnership. A dissolution mechanism is (ex post) efficient if there exists an equilibrium in which the partner with the higher valuation gets the entire partnership and no money is wasted."

50 For the fundamental principles see Cramton, Peter/Gibbons, Robert/Klemperer, Paul, 'Dissolving a Partnership Efficiently', *Econometrica* 55 (1987), 615; and McAfee (note 48), 284.

51 See for example Jehiel, Philippe/Pauzner, Ady, 'Partnership Dissolution with Interdependent Values', *RAND Journal of Economics* 37 (2006), 1; Moldovanu, Benny, 'How to Dissolve a Partnership', *Journal of Institutional and Theoretical Economics* 158 (2002), 66.

52 See de Frutos/Kittsteiner (note 4), 186.

53 See Li/Wolfstetter (note 8), 531.

54 See Li/Wolfstetter (note 8), 547: "However, [a buy-sell provision] always entails an efficiency loss, either in the form of excessive dissolutions, combined with underinvestment, or efficient dissolutions, combined with overinvestment."

55 See Comino/Nicolo/Tedeschi (note 2), 726: "A contract without an asset allocation clause makes the partnership costlier to dissolve and therefore it represents an alternative way in which firms may commit to the alliance."

56 See Brams, Stephen J./Taylor, Alan D., *Fair Division: From Cake-Cutting to Dispute Resolution*, 1996; Morgan, John, 'Dissolving a Partnership (Un)Fairly', *Economic Theory* 23 (2004), 909.

to enter into the partnership in the first place, thereby forgoing any economic gains that may be derived[57]. Recent experiments have shown conclusively that test subjects favoured simple purchase or sale offers over shoot-out clauses[58] and that the efficiency gains arising from auction procedures predicted by standard economic models did not eventuate in the laboratory[59]. This was confirmed, firstly by observations in England and the United States that while shoot-out clauses were often agreed to, they were in fact rarely employed[60]; and more recently, by the revelation that auctions were not as prevalent as buy-sell clauses, much to the bafflement of economists[61].

IV. Validity of shoot-out clauses in partnership and corporate law

1. General validity

Case law on the validity of shoot-out clauses is rare in Continental Europe but somewhat richer in the United States.

a) Austrian case law

A first indication comes from a 2009 judgement rendered by the Court of Appeal in Vienna that approved the inclusion of a "deadlock clause" in the articles of association of a close corporation and the entry of these articles into the commercial register[62]. That decision dealt with a case where the initiating party (Party A) determined the buy out price – without any regard to the commercial or book value, but Party B retained the right, should the price be deemed too low, to purchase Party A's shares for the suggested price. According to the Court, this mechanism has sufficient "checks and balances" to prevent Party A from taking advantage of Party B. Therefore, individual

57 According to Morgan (note 56), 910.

58 See Brooks/Landeo/Spier (note 8), 661 f.

59 See Kittsteiner, Thomas/Ockenfels, Axel/Trhal, Nadja, *Heterogeneity and Partnership Dissolution Mechanisms: Theory and Lab Evidence, Working Paper*, September 2009, p. 9: "In fact, if we compare frequencies of efficient dissolutions, the buy-sell clause weakly significantly outperforms the auction."

60 See also Brooks/Landeo/Spier (note 8), 650: "Despite their widespread inclusion in business contracts, even the most experienced attorneys have rarely (if ever) seen a Texas Shootout clause triggered."; Hewitt (note 3), marg. no. 10-36.

61 See de Frutos/Kittsteiner (note 4), 185 with note 4: "Surprisingly, auctions are rarely considered as an alternative to buy-sell clauses in the literature on corporate law."

62 See Vienna Court of Appeal, judgement dated 20. 4. 2009 – 28 R 53/09h, *GesRZ* 2009, 376 (headnote only).

shareholders are protected from unreasonable disadvantage, meaning there can be no argument that shoot-out clauses should be invalid for being in breach of public policy[63].

b) French case law

In France, shoot-out clauses are used occasionally in shareholder agreements[64], but the shoot-out procedure itself is hardly ever triggered in commercial practice[65]. In 2006, however, the Paris Court of Appeal had to review the validity of such a clause: One of the parties to a shareholder agreement argued that a buy-sell clause actually constituted an exclusion clause which is invalid if it is not part of the articles of association. The Court of Appeal rejected that objection, arguing that a buy-or-sell clause, in contrast to an exclusion clause, cannot be regarded as a sanction: It is an exit procedure voluntarily agreed to by the contracting parties and therefore perfectly valid[66].

c) German legal doctrine

In Germany, shoot-out clauses have not yet been investigated by the courts, however, legal practitioners and academics have tended to confirm their general validity[67]:

– *No direct or indirect limitation of inalienable exit rights:* Shoot-out clauses are not regarded as an invalid restriction of the right to dissolve a partnership according to § 723 (3) BGB (German Civil Code) because each partner is free to initiate the shoot-out procedure[68]. The fact that a partner may exit via a transfer of shares from one partner to another via a right to sell,

63 As stated by the Appeals Court of Vienna, judgement dated 20. 4. 2009 – 28 R 53/09h, *GesRZ* 2009, 376 (headnote only).

64 See Sébastien Prat, *Les pactes d'actionnaires relatifs au transfer de valeurs mobilières*, 1992, n° 158 et seq.; Paul Le Cannu, *Rev. trim dr. comm.* 2007, 169, 170: "En effet, la clause 'achetez ou vendez' (autrement appelée clause d'offre alternative, clause exane, norvégienne, omelette, roulette russe etc.) n'est pas rarissime dans les pactes [...]."

65 See Prat (n. 64), n° 162; Paul Le Cannu, *Rev. trim. dr. comm.* 2007, 169, 170: "Sa mise en application n'est pas courante."

66 See CA Paris, 15 December 2006, *Rev. trim. dr. comm.* 2007, 169, 170: "Une telle condition n'a rien d'illicite; la sortie de la société, consequence de la mise en oeuvre de l'engagement, n'est pas une sanction et n'est pas imposée puisqu'elle a été librement acceptée."

67 See, most recently, Fleischer, Holger/Schneider, Stephan, 'Zulässigkeit und Grenzen von Shoot-Out-Klauseln im Personengesellschafts- und GmbH-Recht', *DB* 2010, 2713.

68 See Schulte/Sieger (note 5), 29; Wälzholz (note 5), 88.

instead of a right to terminate the partnership, is irrelevant in the legal context: the transfer of shares via sale is a functional equivalent to terminating the partnership, thereby providing the safeguarding against a limitation of exit rights required by § 723 (3) BGB just as effectively[69]. The main difference is that the party seeking to leave the partnership may in fact end up as the sole shareholder once the procedure has been carried out. This does not however, conflict in any way with the intent of § 723 (3) BGB, as the effect is the same – the partnership itself has come to an end. The remaining partner may choose to continue operating the enterprise as a sole proprietor, to sell or to liquidate it[70].

– *No violation of the public policy provision:* Moreover, most authors agree that the price determination mechanism of shoot-out clauses usually protects individual partners and shareholders from unreasonable disadvantage, so that a violation of the public policy provision in § 138 (1) and (2) BGB is unlikely[71]. In exceptional circumstances, however, shoot-out clauses may be deemed to be against public policy, if at the outset one of the two partners is not in a position to finance the purchase of the remaining interest, as this might result in the weaker partner adopting an 'avoid at all costs' behaviour as far as the shoot-out procedure and its potential disadvantages are concerned[72]. This argument is called the "Damocles' Sword"-argument and has been developed by the German Federal Court of Justice to strike down termination clauses that allow for arbitrary exclusion of partners and shareholders in close corporations[73]. This rationale may, in appropriate cases, be extended to shoot-out clauses.

d) US case law and doctrine

In the United States, courts treat shoot-out clauses as presumptively fair[74]. The reason for that was most clearly explained in a 2002 decision by Judge Easterbrook who referred to the disciplinary effect of the clause: "The possibility that the person naming the price can be forced either to buy or sell keeps the

69 In a similar case see *BGHZ* 126, 226, 234 ff.

70 See Wälzholz (note 5), 88.

71 See Fleischer/Schneider (note 67), 2717; Schulte/Sieger (note 5), 29.

72 See Fleischer/Schneider (note 67), 2718.

73 See *BGHZ* 81, 263, 268 picking up a phrase by Schilling, Wolfgang, 'Zur Abfindung bei der Ausschließung ohne wichtigen Grund aus einer Personengesellschaft', *ZGR* 1979, 419, 426.

74 See, e.g., *Shilkoff, Inc. v. 885 Third Ave. Corp.*, 299 A.D. 2d. 253, 750 N.Y.S. 2d 53 (N.Y. A.D. 1st Dept. 2002).

first mover honest"[75]. In practice, these clauses are frequently included in business contracts and have become virtually boilerplate in certain business areas such as real estate joint ventures[76]. The American Bar Association (ABA) has published a model agreement drafted under the Delaware Limited Liability Company Act for that purpose in 2008 with an elaborate buy-sell-clause[77].

The official commentary of the model agreement cautions, however, that the buy-sell procedure is based on the assumption that all members of the joint venture have access to the necessary information and capital, general capability and the inclination to bid for the interest of the other member[78]. It goes on to admonish members and managers to bear their fiduciary duty of candid disclosure in mind during this process. If the member who invokes the buy-sell-provision is a manager, that member-manager must disclose to the other member material information regarding the LLC and its value that the other member may not have. This disclosure obligation was confirmed in a 2002 court decision: The 50% member-manager of a single-project LLC (owning a commercial building in New York City) purchased the other 50% member's membership interest and two weeks later had the LLC sell the building for a price that was 250% higher than the purchase price of the co-member's membership interest. The court held that the member-manager violated his fiduciary duty, adding that the seller cannot waive or disclaim its right to those fiduciary protections in connection with the transaction because, to be valid, the seller must have made an informed decision to grant the waiver[79].

2. *Potential for abuse*

Contrary to premature conclusions drawn by some authors, the shoot-out procedure cannot guarantee that all interests are equally met in any given case. There are some typical fact patterns where the "checks-and-balances"-argument does not hold. Most importantly, the ploy of switching the purchasing role to ensure fairness falls flat where Party B is not in a financial position to purchase Party A's shares[80]. Although this "access to cash" problem[81] may

75 *Valinote v. Ballis*, 295 F.3d 666, 667 (7th Cir. 2000).

76 See Brooks/Landeo/Spier (note 8), 650.

77 See American Bar Association, Model Real Estate Development Operating Agreement with Commentary, 63 *Bus Law.* 385, 472 ff. (2008): Article IXA BUY-SELL.

78 See American Bar Association (note 74), 474 note 222.

79 See *Blue Chip Emerald LLC v. Allied Partners, Inc.*, 299 A.D. 2d 278, 750 N.Y.S. 2d 291 (N.Y. A.D. 1st Dept. 2002).

80 See Fleischer/Schneider (note 67) 2717; Johansson (note 6), 301.

81 Hoberman (note 3), 248.

be ameliorated by obtaining financial assistance from external sources[82], it cannot be completely eliminated. Where Party A is aware of Party B's limited financial resource, the temptation to "low-ball" exists[83]. Drawing on the language adopted in anti-trust law for this strategy, relevant literature makes reference to the "predatory potential of Texan Shootouts"[84].

a) US case law

This exploitation of financial weakness for one's own benefit has woken the protective instincts of the courts. In the US, different findings as to its permissibility have been handed down. One decision from the Court of Civil Appeals of Texas dealt with a buy-sell agreement between joint venture partners in a real estate company. The Court found evidence that Party A had made an offer under market value based on the knowledge that Party B was not in a financial position to pay the purchase price[85], and rescinded the subsequent sale of Party B's shares[86]. In contrast, the District Court of Minnesota did not find a breach of fiduciary duty in a similar case, where an offer to buy, made as part of a buy-sell agreement was clearly below market value: "It 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 […]."[87] According to a third decision, rendered by the Court of Appeals of Ohio, conducting negotiations in compliance with a partnership agreement also creates a fiduciary duty if a partner uses his position to obtain a financial benefit[88].

82 See Schwarz (note 7), § 20 marg. no. 15, according to which even the financially weaker can obtain financing for a good price.

83 See also Brooks/Landeo/Spier (note 8), 665; Carey (note 3), 651; Hewitt (note 3), marg. no. 10-26; Hoberman (note 3), 248.

84 Brooks/Landeo/Spier (note 8), 665.

85 See *Johnson v. Buck*, 540 S.W.2d 393, 411 (Tex. App. 1976).

86 This case did feature one unusual characteristic, in that the buy-sell agreement was only made after the initial partnership agreement, and Party A had provided inaccurate information to Party B regarding the state of the business; see Carey (note 3), 672: "The result might have been different in the absence of misrepresentation if specific buy/sell provisions were included."

87 *Larken Minnesota, Inc. v. Wray*, 881 F.Supp. 1413, 1421 (D.Minn.1995).

88 See *Schaefer v. RMS Realty*, 741 N.E. 2d 155, 175 f. (Ohio Ct. App. 2000).

b) German legal doctrine

In Germany, without an explicit agreement in the exit clause, it could hardly be supposed that any duty of good faith was imposed upon Party A to offer an appropriate price, i.e. a price that represents a "good faith estimate"[89] as part of a shoot-out procedure. This would overstretch fiduciary duty, which is intended to impose limitations on partner behaviour, rather than optimising it[90]. However, a legal remedy might be available when there is a large discrepancy between the price offered and the actual value of the shares. A "low ball"-offer made by Party A in knowledge of the financial weakness of Party B may run afoul of the principle of good faith and fair dealing (§ 242 BGB) and the fiduciary duty already existing in partnership and close corporation law[91]. Where the offer is excessively low, there may even be room for a factual assumption that Party A knew about his co-partners' financial distress and sought to exploit it to his own advantage[92].

Moreover, Party B also deserves judicial protection when the financially stronger Party A deliberately engineers a trigger event, e.g. a deadlock situation, to force Party B out of the partnership at an economically convenient time, possibly also on unfair terms. In that case, the courts might deem a trigger event not to have happened if it was brought about in breach of good faith. In terms of contract interpretation, a recent English decision on buy-sell clauses is already leading the way in this approach[93]. The German Federal Court of Justice came to a similar conclusion in a slightly different context; a partner cannot rely on a mutually agreed continuation clause to defend actions carried out in bad faith[94].

V. Contractual design and safeguards

As seen, shoot-out clauses can lead to disadvantages for the financially weaker partner. To limit the potential for abuse, legal practice provides a range of

89 Carey (note 3), 671 (2005).

90 For general information regarding fiduciary duty, see Schmidt, Karsten, *Gesellschaftsrecht*, 4th ed. 2002, § 20 IV, p. 587 ff.; Wiedemann, *Gesellschaftsrecht*, vol. II, § 3 II 3, p. 191 ff.

91 See Fleischer/Schneider (note 67), 2717.

92 In this sense Fleischer/Schneider (note 67), 2717 pointing to the economic rationale behind shoot-out clauses.

93 See *T-Mobile (UK) v. Bluebottle Investments SA*, [2003] EWHL 379 (Comm); see also the interpretation offered by Hewitt (note 3), marg. no. 10-28 together with note 10: "The court held, on the facts, that the party could not misuse an exit clause in this way."

94 See *BGHZ* 30, 195, 201 f.; BGH, *NZG* 2008, 623, 626.

different potential solutions, which promise varying levels of success. A contract clause that requires both partners to do what they can to prevent deadlocks[95] is redundant in Germany, as this obligation already exists as a result of the fiduciary duties between partners. A clause requiring that any offers made as part of a shoot-out procedure must equate to a "good faith estimation"[96] of the market value is theoretically attractive, but difficult to implement in practice. Providing the financially weaker party with a fixed time frame, usually between 30–60 days, to arrange the necessary financing, or allowing purchase on deferred terms may prove to be a more practical solution[97]. As an alternative or additional measure, the right to seek a third party to purchase the interests in the company may be provided[98]. Agreement to a blackout period is also conceivable, to prevent the termination procedure from being initiated until after the project has been stabilised[99].

Even with contractual safeguards, the use of shoot-outs, particularly in the presence of a large financial disparity between the partners, must be approached with caution[100]. While they are by no means perfect[101], they are worth considering in the formation of a partnership. Their value does not appear in the implementation of the procedure, but rather before it; rationally dealing partners, faced with the uncertainty and finality of a shoot-out procedure may in fact be more inclined to retake their seats at the negotiating table[102].

VI. Summary

1. Shoot-out clauses were developed in Anglo-American legal practice as a means of resolving deadlocks in two member partnerships or close corporations. Their use allows one of the two partners to purchase all interests in the partnership according to a strictly formalised price identification process. In Germany, they are being recommended more often for use in joint venture and

95 See Hoberman (note 3), 243.
96 See Hoberman (note 3), 248 f.
97 See Brooks/Landeo/Spiers (note 8), 665; Carey (note 3), 674; Hoberman (note 3), 248.
98 See Carey (note 3), 674; Hoberman (note 3), 248.
99 See Carey (note 3), 674; Hobermann (note 3), 245 ff.
100 Urging caution Brooks/Landeo/Spier (note 8), 665; Fett/Spiering (note 5), § 7 marg. no. 600; Schwarz (note 7), § 20 marg. no. 15; Wälzholz (note 5), 89.
101 See also Carey (note 3), 655: "Like any other exit strategy in which the venturers' interests are not aligned, a buy/sell is by no means perfect.", similarly Hewitt (note 3), marg. no. 10-36: "None of these measures is an ideal solution."
102 See also Brooks/Landeo/Spier (note 8), 665; Carey (note 3), 656; Hewitt (note 3), marg. no. 10-36.

venture capital contracts, in the form of Russian roulette, buy-sell agreements and sale shoot-out clauses.

2. Shoot-out procedures provide a high level of fairness in price determination, thanks to the cake cutting rule ("I cut, you choose"). Game theory researchers however have found that buy-sell clauses are often inefficient ex post. They recommend instead that parties use an auction procedure to ensure that shares in the partnership end up in the hands of the partner who values them most.

3. In principle, shoot-out clauses are valid. US courts treat them as presumptively fair. Under German law, they do neither directly nor indirectly limit the inalienable exit rights in partnership law (§ 723 BGB), nor do they usually violate the public policy provision (§ 138 BGB). In exceptional cases, however, they may be deemed to be against public policy, if at the outset one of the two partners is not in a position to finance the purchase of the remaining shares, as this might result in the weaker partner adopting 'avoid at all costs' behaviour as far as the shoot-out procedure and its potential disadvantages are concerned ("Damocles Sword"-argument).

4. The shoot-out procedure, despite its inherent fairness, cannot guarantee that all interests are equally met in any given case. Its predatory potential becomes obvious when one party knows that the other party is unable to pay the purchase price and exploits his financial weakness by a "low ball"-offer. US courts are split on whether such behaviour violates the fiduciary duty of co-partners. In Germany, such a predatory offer may run afoul of the duty of good faith and fair dealing (§ 242 BGB) and the fiduciary duty in partnerships and close corporations.

5. The potential for abuse of a shoot-out procedure to the disadvantage of the financially weaker party can be mitigated by including appropriate safeguards in the partnership agreement. Nevertheless, where a large disparity between the partners exists, shoot-out clauses should be applied with caution.

6. Finally, practical experience from England and the United States has shown that although shoot-out clauses are often included in partnership agreements, they are only rarely executed, meaning that their value lies more in their deterrent effect with regard to termination.