

Deadlock Provisions in Agreements – Say No to the Rochambeau Method



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September 17, 2019

For LLCs or Corporations with a small number of members or shareholders, and with relatively equal ownership and management, a provision to deal with a deadlock is critical. This type of provision is typically located in the LLC Operating Agreement or a Shareholder Agreement, but could be a separate agreement among the Members or Shareholders. Without this provision, or a way to break a deadlock or tie, the parties could be trapped into the entity, without a way to conduct business.

Deadlocks occur many different ways. The most common way to have a deadlock is to provide that each owner has an equal share in the management. If your ownership is 50/50, it is quite easy to end up with a 50/50 split, or equal share, in management. If one owner wants to order sandwiches for the staff lunch that day and the other owner wants pizza, you could have a deadlock. Thankfully, we don't usually see deadlocks over the lunch order, but we do see them over non-ordinary course decisions of the business: should we start making these other widgets, should we make this critical executive hire, should we relocate the headquarters, and should we enter into this long-term contract for this set price, are just some examples. These are business decisions outside of the ordinary course, that put the Company at risk, and for which owners or managers could have differing views.

In drafting a deadlock provision, you first need to define what a deadlock is. In my example above, we like to keep the deadlock within a set of neatly defined items - extraordinary actions – so that it's not a trivial disagreement. "Extraordinary Actions" or "Fundamental Issue" are used as the basis for a deadlock because those are actions outside of the ordinary course. Owners and managers should be able to expect that the business takes care of what it has in the past. If it's always performed contracts in about the same way, it's not extraordinary to continue that practice. If this is a new type of contract and has different terms from the "ordinary" type, we should examine it at a higher level, which could lead to a deadlock. Additionally, we also typically include fundamental issues, because those affect the fundamental nature of parties' ownership in the business. If the owners have an offer to sell the Company, or merge that changes the fundamental investment they made; instead of ownership in a Company, you have cash or a promissory note.

After you have defined what a "deadlock" is, the provision outlines a procedure for resolving the deadlock. There are about as many ways to resolve a deadlock as there are to get into a deadlock, but some of the most common ways are listed below:

- Have the parties/executives meet and try and resolve the differences for a set period of time

Deadlock Provisions in Agreements – Say No to the Rochambeau Method (Cont.)

- Have the parties work with a third-party mediator for a set period of time
- Have the parties work with an arbitrator (this can be dangerous – go carefully!)
- Have one party make the ultimate decision (coin flip? Rochambeau? Alternate the decisions?)
- Have one party buy the other party out

Most approaches use a few of the methods described above. I typically have the parties stew over their disagreement for a week or two. Then, if they still have this disagreement, the members/manager can meet to try and work through the differences, again over a week or two. It's important to give some time for this process, but not too long. If it's a fundamental disagreement, you need to be able to wrap up things quicker, rather than after the business has failed.

If there is still no progress after these initial steps, then one party (the "**First Party**") can make an offer to buy out the other party (the "**Second Party**") for a stated price. The Second Party can then accept the purchase offer, or turn it around and buy the First Party out pursuant to the same terms! It requires the First Party to make a good offer price, or they may find themselves needing to sell at the too-low price. This method is sometimes called a "Russian Roulette" provision and is dramatic, but effective and quick. Of course this method favors the party with the most information about the Company (perhaps knowing what would be a good purchase price, and if it is worth the amount being offered or not), and the party that has the most liquid cash.

Of course, there are other ways to solve a Deadlock through the sale/purchase of the ownership, like having sealed bids for the purchase and the highest bidder buys out the other owner at that highest price (likely the same result with respect to knowledge about the Company and amount of money), or perhaps a sealed bid where the highest bidder buys out the lowest bidder at that lowest bid price. In the last example, the owner who puts the highest value on the Company wins.

Don't forget to keep in a provision that the Company should continue to operate in the ordinary course during the time the owners work through the deadlock. Just because they have a disagreement about one part of the business, the other parts shouldn't be ignored.

Finally, to drill in the point that this is important, if you don't have a deadlock provision, it's possible that the Company is not able to operate at all. If you have two owners who both participate in management, and they don't agree on basic business terms, the Company can't function. The Company may be able to continue to execute and perform its "ordinary" work, but can't make other decisions – fire/hire key employees, move office locations even if rent triples, stop making the widgets that lose money. If you are working through an LLC entity, in most states, a member doesn't have the right to withdraw from the Company. In that case, because the dissenting member must remain a member, he/she/it cannot go out and compete against the Company like he/she/it wants. That Member is bound to, and with, the Company.

Some states, like Delaware, offer a remedy to judicially dissolve the Company, but only when "it is not reasonably practicable to carry on the business." It is granted sparingly. The best solution is to think through all factors carefully *before* taking any action.