May 15, 2012

Basic Considerations in Negotiating the Issues Related to the Removal of a Manager of a Joint Venture

By: Michael J. Changaris, Esq.
760.496.0771 | mike.changaris@procopio.com

A typical joint venture arrangement involves one group providing most of the capital for the venture (the "Investors"), and another group or entity being responsible for running the day-to-day business (the "Manager"). Most often, the economic structure provides that cash is distributed first to the Investors until they have received a preferred return or internal rate of return on their investment, together with the return of their investment, and then a "shift" of the economic sharing ratios for the benefit of the Manager, e.g. all of the cash may go to the Investors until they have received an agreed-upon rate of return together with their investment, and thereafter, cash distributions are split, say, 75% to the Investors and 25% to the Manager. The Manager is receiving a share of the profits in excess of its capital investment (if any). The excess profit share is commonly referred to as a "Promote."

In these situations, it is common for the Investors (especially institutional investors) to negotiate to have the right to remove the Manager either for "cause" or "not-for-cause." In negotiating removal provisions, there are a number of concepts for the Manager to consider, and this article briefly reviews a few of the more basic of those concepts.

1. From the Manager's perspective, it is important to draw a clear distinction between "cause" and "not-for-cause," because removal of the Manager for "cause" typically results in a complete loss of the rights to the Promote, whereas removal not-for-cause will often permit the Manager to continue to benefit from the Promote. While it is not uncommon for Investors to try to include as a "cause" event failure to achieve specified performance results, the Manager should resist that treatment. As a practical matter, the Manager will want to limit terminations for "cause" to "dark of the heart" types of conduct such as a court determination of willful bad conduct or gross negligence. Failure to achieve performance results may have nothing whatsoever to do with the efforts and capacities of the Manager, but instead are due entirely to market or other conditions.

2. If removal is allowed, the Manager should require that the Investors in the venture remove the Manager from any venture guarantees, and if not removed, agree to indemnify the Manager from any losses suffered in respect of company-level debt until the guarantees are terminated. Depending on the financial capability of the venture, the Manager may consider insisting that the Investor(s) separately guaranty the indemnification obligation.

3. In the case of not-for-cause removals, the Manager will also want to protect the inherent value of the Promote accrued up to the time of removal. This can be accomplished by either requiring a current payout of the accrued Promote (based on a hypothetical sale of the venture at fair market value), or a "book up" to the Manager's capital account, with a requirement that book up amounts be distributed as a part of the distribution waterfall.

4. If the Manager does not wish to continue to be a part of the venture if removed, the Manager will want to require the venture to buy out the interest of the Manager (both the Promote and equity positions, if any). Ideally, the buy out will be on an "all cash" basis at closing. If the buy out is on terms, to be paid over time, the Manager should assure itself that it has adequate

security for the payment of the buy out price. Alternatively, if the Manager is willing to continue as an owner of the venture, care should be taken to assure that the Manager has adequate voting rights, and can protect itself from venture document changes that would adversely affect (directly or indirectly) its economic rights, e.g., clarify that without the vote or consent of the Manager, there can be no changes in the Manager's allocations and distributions, or other compensation opportunities and no amendment of the venture documents that would impose greater financial risk, obligations or expense on the part of the Manager.

The removal provisions in venture documents can be particularly complex, involving a careful analysis of not only the removal provisions themselves, but the impact of those provisions on management rights, economic obligations and rights, tax allocation provisions, venture termination rights and applicable buy out provisions. Managers are well advised to have the assistance of experienced counsel in structuring and negotiating these types of agreements.

Mr. Changaris' practice emphasizes corporate and partnership merger and acquisition transactions for public and private companies; negotiation of joint venture relationships involving foreign and domestic corporations, partnerships and limited liability companies; tax-exempt financing transactions and other corporate and business transactions; Federal, state, local and international tax planning and structuring for corporations, partnerships, REIT's and tax-exempt organizations. Reach Mr. Changaris at 760.496.0771 or mike.changaris@procopio.com.