State Law & State Taxation Corner

Rock, Paper, Scissors, Lizard, Spock and Other Innovative Dispute-Resolution Mechanisms

*By Thomas E. Rutledge**

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It is something of a truism that the organizational documents we prepare are only relied upon by our clients in times of disagreement and conflict. Seldom, during the pendency of a successful venture in which the participants view themselves as receiving their justly deserved benefits, will the documents be referenced. It is only when there is conflict that the documents are carefully reviewed in order to see who has what rights *vis-à-vis* either the venture or the other participants therein.

One common situation that must be addressed is deadlock. Whether the venture has two owners participating in management with equal rights, a board structure in which half of the directors are appointed by one body and half by another, or some other structure in which equally powerful groups may be formed, the possibility of deadlock needs to be recognized and a mechanism created by which, typically but not always short of dissolution, the dispute can be resolved.

The Simple Answer—Buy-Out

It is quite common to see a buy-out utilized as the means by which an actual or potential deadlock will be resolved. Essentially, if one camp is dissatisfied with some aspect of the venture, then there is triggered a mechanism by which one side buys out the other. Often based on so-called Chinese Auction or fair value/fair market value valuations,[1] all too often it is forgotten that the buy-out is a blunt force approach.

Initially, a buy-out compels the buyer to significantly increase, often substantially, its investment in the venture. Assume a venture, Consolidated Resources, in which Camp A has invested $10 million just as Camp B has likewise invested $10 million. After a year, the value of the enterprise has increased by 30%, a deadlock situation arises, and Camp B is to buy-out Camp A. Assuming they are valuing the venture on a fair value basis, Camp A must pay to Camp B $13 million. True, Camp B will now have sole control over a venture with a value of $26 million, but only by means of investing $23 million, an amount $13 million higher than it originally intended to devote to these operations.

Consider as well the possibility that Camp B has been approached about an investment opportunity, Diversified Resources, generating a 45% annual rate of return. Camp B is aware that the ROI on the Consolidated Resources venture is 30%, and the math wizzes at Camp B are able to determine that 45% is better than 30%. They have also determined that the only source of funds by which to invest in Diversified Resources is the liquidation of the investment in Consolidated Resources. Camp B has an obvious incentive to game the system to liquidate the Consolidated Resources investment—"tell me again the definition of a 'deadlock'?" The CFO asks the attorney in an effort to find a way to trigger the definition and the buy-out.

Clearly, the existence of a buy-out affords Camp B the opportunity to effect the liquidation of one investment in order to reapply those funds in a venture with an expected higher rate of return. It is at best doubtful that this was, at least in the view of Camp A, the intended function of the dispute-resolution/buy-out provision.

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The Need for Other Options

Disputes among participants in a business venture must be expected. The obligation of the drafter of the venture's organic document is to craft mechanisms by which those disputes can be resolved so as to preserve the value of the venture for those participants. As noted above, a right to compel a buy-out is subject to abuse in that the buyout can be gamed for purposes of a benefit outside the terms of the existing venture. For that reason, other alternatives need to be considered.

The (or at least a) place to begin is by categorizing the matters that may be disputed. Some will be ordinary in nature, typically involving degree. That the venture should expand its physical plant is not disputed—the question is whether to expand to accommodate the next three or the next 10 years of anticipated growth. Other disputes will be extraordinary, involving either (i) a disagreement as to whether to act (either expand the physical plant or do not) or (ii) a conflict of interest transaction. But what is deadlock?

An appropriate definition of what is a "deadlock" is the gateway to the application of the rules crafted to be applied in the presence of a deadlock. This presents, obviously, a delicate balancing act. The threshold should not be defined as too low or it will all too often need to be employed. Alternatively, if set too high, there may well be opportunities in which it should be employed but cannot. Also, there is the risk that there will be a dispute as to whether or not the contractually defined terms have been satisfied. Keep in mind that these are provisions that, even more than most, will be applicable if and only if the decision-makers are unable to come to agreement.

By way of example, consider a provision that defines deadlock as the inability of the decision-makers to come to agreement as to a "major" issue within 30 days. At this juncture, there is left unresolved what is a "major" decision while a timeline, 30 days, is agreed to, the agreement is silent as to from when that 30 days is measured. Does that period begin to run when the issue requiring resolution is first identified, from the date it is first discussed, from the date the decision-makers first disagree as to its resolution or some other point in time? What will be the treatment if one of the decision-makers simply refuses to attend meetings, thereby precluding the existence of a quorum to consider the matter of itself constitutes a deadlock as to its resolution?

As with so much else, context matters. What is a deadlock amongst the co-managers of a hedge fund may well and likely is going to be different from what is a deadlock between two siblings who have inherited a company founded by their parents in which, while each is a 50% owner, only one is, on a day-to-day basis, actively involved in management.

(1) After deadlock, however defined, the matter will be referred to a vote of a majority of the disinterested participants.

Venture is a limited partnership with two general partners, brothers Alex and Jordan. The partnership may act only as Alex and Jordan agree; neither may act unilaterally. Successful developers of multi-family residential properties, the current project has been capitalized by 50 $10,000 investments. By coincidence, each of those 50 limited partner investors is an out-of-state dentist. Alex and Jordan have had a falling out and are no longer cooperating. This absence of cooperation is at a critical time—final fitting out of the new complex is about to begin together with marketing efforts. The complex is adjacent to a major university, and filling it with students is crucial to the business plan. If the window for student leases is missed, the project will at best struggle for at least a year.

As alluded to above, the agreement of limited partnership for this particular venture provides that, upon a deadlock

between the general partners, the determination will be made by a majority of the disinterested limited partners. In this instance, every limited partner is disinterested. That said, the suggested mechanism for resolution of disputes is likely going to entirely fail. Soliciting the directions of those limited partners is going to entail a significant cost in educating them as to the available options and their respective pros and cons. In light of their unwillingness to cooperate, Alex and Jordan will undoubtedly dispute what question should be presented to the limited partners and what information should be provided to them in connection with any decision. Even if those matters can be resolved, it is highly questionable whether the limited partners have the training and sensitivity necessary to make these determinations. Rather, while each may be an entirely competent dentist, likely none of them has any experience in assessing options for fitting out apartments that are aimed at the college/graduate student population. Simply put, the mechanism provided for in the agreement for resolution of deadlock between the general partners is little different than asking either Alex or Jordan the best way to address periodontal disease.

Further, in light of the fact that the various limited partners are being asked to opine on something outside of their respective business competencies, it would not be surprising that the response rate will be quite low.

Ultimately, the deadlock-resolution mechanism provided for in this limited partnership agreement is, on the actual facts, ineffective.

(2) After deadlock, however defined, by a majority vote of the disinterested limited partners, someone, who may be affiliated with any of the general partner control groups or not, shall be elected as an additional general partner.

Essentially, this option entails, essentially, a reallocation of controlling authority between two general partners, each of whom had a veto right, into a triumvirate in which any individual general partner may be outvoted. While, conceivably, it addresses the original structural weakness of the limited partnership, namely, deadlock among the general partners, it shares many of the weaknesses of the prior option.

The appointment of a new general partner will vest in that individual the capacity to make decisions on behalf of the limited partnership. As such, the limited partners will only determine who should be that partner, relieving them of the obligation, as set forth in the option above, to make a substantive decision. In that respect, this could be considered a lowercase republican notion in which the voting class elect representatives who in turn make decisions on their behalf. A classic problem of Republican democracy is the quality, or the lack thereof, of a slate of candidates,[2] a problem only exacerbated in this situation. Essentially, how are our 50 out-of-town dentist limited partners to locate one or more candidates to serve as the third general partner? There is no easy mechanism by which to advise potential candidates that there is a rating into which a hat may be thrown. Ultimately, it may be that there will be two candidates for that third general partner position, one selected and supported by Alex and the other selected and supported by Jordan. Human nature (unfortunately) being what it is, we would fully expect that Alex's candidate will agree with his views, while Jordan will nominate a candidate who will agree with Jordan as to the path forward.

Which returns us to the same problem with respect to the vote of our 50 out-of-town dentist limited partners. None of them have expertise with respect to the build-out and marketing of apartments. It was for that reason that allowing the limited partners to break the deadlock between the general partners was, operationally, deficient. Under this option, that same problem is continued, only wrapped in a slightly different wrapper. In effect, the limited partners are again being called upon to choose between Alex and Jordan, only this time acting through the proxy of a third general partner.

Assuming, of course, that each of Jordan and Alex are able to find potential candidates. Becoming a general partner of a limited partnership will subject that new general partner to a variety of fiduciary obligations, and in the current contentious environment, any newly appointed general partner should expect litigation will result. Notwithstanding rights of indemnification, relatively few individuals will likely be interested in that role. Ultimately, we are left with a flawed selection process for a new general partner, the limited partners being restricted to selecting from only candidates who may well be less than attentive to fiduciary obligations and related exposure.[3]

(3) After deadlock, however defined, the matter shall be automatically referred to binding arbitration amongst the two existing general partners. The determination of the arbitrator shall be final and conclusive. It is further provided that the general partner's performance in compliance with the terms of the arbitrator's ruling shall not constitute a breach of their fiduciary obligations.

This proposal has the objective merit in that it may place the ultimate determination in the hands of someone with a similar level of expertise to our general partners, that being achieved by defining the minimum characteristics of the potential arbitrator. Of course, this assumes that such an arbitrator can be located. Each time an additional characteristic is added, the pool of potential arbitrators is reduced. Each iteration from "experienced in real estate

developments" to "experienced in multi-family real estate development" to "experienced as a general partner overseeing a multi-family residential development" to "experienced as a general partner overseeing a multi-family residential development within 150 miles of Cincinnati, Ohio" serves to make it less likely that a qualified arbitrator can be found. Assuming our general partners are able to come to agreement as to who should be the arbitrator or, in the alternative, that the document contains a well-structured mechanism by resolving any disagreement should it arise, this may be an effective mechanism of resolving any dispute between Alex and Jordan. It does however, effectively vest ultimate control over the direction of the venture in one who is not either a general or a limited partner and who, as of the time of any limited partner's investment, is unknown to it.

It is only when there is conflict that the documents are carefully reviewed in order to see who has what rights vis-à-vis either the venture or the other participants therein.

(4) The Trusted Advisor Tie-Breaker

Under this procedure, in the event of a deadlock between Alex and Jordan, a pre-identified trusted advisor will be entrusted to break the deadlock and determine how the venture will proceed. Doing so, without more, begs the question of the nature of the relationship into which that advisor has entered.

For example, the LLC at issue in *Fakiris v. Gusmar Enterprises, LLC*[4] involved two equal members (Fakiris and Kostas) whose operating agreement provided that Neubauer, an apparently long-term and trusted employee of the venture, would have a tie-breaking vote. When acrimony arose between the two members, Neubauer "relinquished her authority to cast the decisive vote."[5] When litigation followed, one of the members sued the LLC, the other member and Neubauer, it being asserted that Neubauer was a fiduciary to the plaintiff. The court denied her motion for summary judgment on the claim "that Neubauer breached her fiduciary duty by refusing to resolve stalemates between the plaintiff and Kostas."[6]

In hindsight, Neubauer should have insisted that the agreement (i) define her as not being in a fiduciary relationship, (ii) contain a waiver of all claims arising out of any tie-breaking vote she might cast, and (iii) likewise waive any claim that might arise from a failure to cast a tie-breaking vote.

(5) Trial by Combat[7]

Let us for now set aside the fact that dueling, which likely encompasses trial by combat, is illegal in most states[8] and that a court likely would not enforce any agreement for trial by combat[9]; it is still fun to consider. Assuming enforceability, what would be the rules? Must each of the parties to the disagreement personally engage in the combat, or is the hiring of a champion permitted? If a champion is permitted, what are the outer parameters thereof? Must there be a pre-existing employment relationship with the champion, or is it permitted that the champion may be anybody willing to accept the engagement? Alternatively, if the champion must be a particular person within the organization such as the chief financial officer, must there be an incumbency requirement so that, on the eve of designating the champion for trial by combat, the former CFO is not terminated and replaced with a "ringer."

From there, what will be the terms of the trial? Is this a battle to the death, to significant bodily injury, or to the point where one of the combatants concedes? Will the weapons, if any, be determined in advance by the contract, or will they be mutually agreed upon between the ultimate combatants? If they do not agree, what mechanisms will be employed to make that determination?

(6) Appoint a committee of limited partners who have the authority, in the event of a deadlock, to cast a single vote and thereby break the deadlock.

This option has some of the problems incident to option (1), but on a reduced scale. Rather than requiring a vote of all of the limited partners, it requires the involvement of only those limited partners who agree to serve on the committee. It is assumed that both (a) some limited partners are willing to serve, and (b) the members willing to serve are not so numerous as to render the working of a committee nonfunctional. It may, therefore, be necessary to create a mechanism by which limited partners presumably self-nominate to the committee,[10] and to the degree the nominations exceed the committee's size, there is a sorting mechanism by which the requisite number is determined.

The committee could be constituted either: (a) at the time of the partnership's formation or (b) from time to time as required. If the former, there will be the issues of how changes in composition are to be handled. For example, if a committee member limited partner should die or dissociate from the partnership, will a replacement be: (i) selected by the balance of the committee's members; (ii) be appointed by the general partners; or (iii) selected by a general vote of the limited partners?

But even once fully constituted, referral of the

deadlocked question to the committee revises the same problem as was identified above for a general vote of the limited partners, namely, the lack of expertise to make a decision. Just as a majority of our dentist limited partners lack the skill set to make a decision as to the fit-out of an apartment complex, so likely is any committee of those limited partners likewise deficient. They may make a decision if only because no decision is likely more costly than inaction, but there can be no assurance that the best decision will be made.

What then should be the obligation of the committee and its constituents to the limited partnership and the other partners? Should they, exercising control over the limited partnership as to this determination, be subjected to the same fiduciary duties as apply otherwise to the general partners, should they be held to a reduced fiduciary standard, or should they be exempted entirely from fiduciary exposure?

Let us assume that the limited partners on the committee should be freed of fiduciary obligations; they are being called in as a last-ditch effort to resolve a matter as to which the general partners cannot agree (*i.e.*, upon which reasonable minds could differ) and outside of the expertise of the committee members.[11] But is that achievable? While ULPA (2001) likely contains sufficient flexibility to in this case sufficiently reduce any fiduciary duty of care owed consequent to participation on this committee,[12] it is less than clear that in those states still utilizing the Revised Uniform Limited Partnership Act (1985)[13] that (a) the limited partners do not owe fiduciary duties[14] or (b) that the fiduciary duties are subject to restriction or waiver.[15]

(7) Rock, paper, scissors, lizard, Spock.[16]

Aficionados of the show *The Big Bang Theory* will already be familiar with the game "rock, paper, scissors, lizard, Spock." An expansion upon the classic rock, paper, scissors, it continues the pattern of each weapon, as selected, being superior to an equal number of alternative weapons to which it will succumb. Setting aside nonrandom conduct in each iteration of the game employed after any tie, the expanded version of the game simply increases complexity as to both the available weapons and the ability to remember the rules.

But may the general partners, in the resolution of any disagreement between them, resort to such a random means of resolution?[17] Absent a provision in the relevant partnership agreement allowing the general partners to do so, the case can be made that doing so constitutes a failure to act on an informed basis and rather, in opposition to fiduciary obligations, empowers chance to govern the operation of the limited partnership. Conversely, were that mechanism to be detailed in the partnership agreement and approved by the limited partners, it should be acceptable. In doing so, however, the limited partners would be affording Alex and Jordan an "out" in resolving their disputes such as by collecting additional information, rather, a quick resort to this mechanism, assuming approval by the limited partners, may inadvertently reduce the degree of care that the general partners would otherwise employ.

(8) Jump Ball.

The purpose of this mechanism is to rely upon the lack of information as to further disputes, and as well the selfish interest of each of Alex and Jordan on the rightness of his views of the current dispute, to drive a compromise resolution. Essentially, it is provided that in the event of disagreement, either general partner has the right to declare a deadlock. However, in declaring a deadlock (i) it is agreed that the partner *not* making the declaration gets to resolve the current deadlock, and (ii) the party declaring the deadlock is enabled to resolve the next declared deadlock, even if self-declared.

In the first instance, neither Alex nor Jordan will want to declare a deadlock as that will vest in the other the ability to control the outcome of the dispute. Second, while declaring a deadlock will give whoever does so the right to control the next dispute, there is no way to know what will be the nature and magnitude of that dispute. Further, before declaring the first deadlock and thereby taking control of the next deadlock resolution, it must be known that the other partner could manipulate the next dispute, causing the power to resolve the next dispute to be spent on something comparatively innocuous.

Of course, in light of those uncertainties, neither partner might declare a deadlock, in which case the resolution mechanism fails to be effective.

This column is demonstrably short of specifics, but only because the available options are generally so deficient. In vesting control of a venture in one or more persons, trust in their judgment and expertise is expressed. When control is vested jointly in two or any even number of persons, there is the possibility of deadlock. The fiduciary obligations that limit and guide their conduct preclude easy compromise in situations of an honest difference of opinion as to how to proceed forward. "I think you are wrong, but I'll go along with you to keep the peace" is not conduct evidencing either an informed decision or one calculated to be in the best interest of the venture. Resolution of a deadlock necessarily raises questions of the fiduciary obligations of the tie-breaker.

But first the drafter needs to conceive of a dispute-resolution mechanism that is a credible response to that possibility.

ENDNOTES

* The author thanks Christina Houston for the question that gave rise to this column, and to David Tingstad for helpful thoughts.

1 By design, this column does not address the strengths and weaknesses of valuation on a fair value versus fair market value basis, the disadvantages of a "Chinese Auction" (a/k/a "slice of the pie") when the parties do not have similar incentives and similar resources, and related matters.

2 Sadly, "none of the above" seems never to be an option.

3 Yes, dependent upon the underlying law, those fiduciary duties might be restricted or even eliminated, but at the same time do you, as a limited partner, want to be placing control of the venture in the hands of persons who are unwilling to accept fiduciary exposure as to the discharge of their obligations?

4 2016 NY Slip Op. 51665(u), 2016 WL 6882889 (N.Y. SCt Nov. 21, 2016).

5 Slip op. at 2.

6 Slip op. at 8.

7 *See*, *e.g.*, *www.atlredline.com/trial-by-combat-it-was-real-and-spectacular-1575163115; www.silive.com/northshore/index.ssf/2015/08/real-life_game_of_thrones_layw.html.*

8 *See*, *e.g.*, Miss. Code §97-39-1 ("every person who shall challenge another to fight a duel … or who shall accept any such challenge or message … shall, on conviction thereof, be fined in a sum not less than three hundred dollars nor exceeding one thousand dollars, or be imprisoned not less than six months in the county jail, or both."); N.M. Stat. §30-20-11; Ky. Rev. Stat. Ann. §437.030:

> Any person who, in this state, challenges another to fight with any deadly weapon, in or out of this state, and any person who accepts the challenge, shall be fined five hundred dollars ($500) and imprisoned for not less than six (6) nor more than twelve (12) months. Any person who knowingly carries or delivers such a challenge in this state, or consents in this state to be a second to either party shall be fined one hundred dollars ($100) and imprisoned for thirty (30) days.

See, generally, Clayton E. Cramer, Concealed Weapon Laws of the Early Republic—Dueling, Southern Violence, and Moral Reform (1999).

9 *See McNatt v. Richards*, Civ. Act. No. 6987, 1983 WL 18013 (Mar. 28, 1983); *see also International Union, United Automobile Workers, Local No. 386 v. Wisconsin Employment Relations Board*, 46 NW2d 185, 189–190 (Wisc. 1951) ("The employer and the employees have no right or power by contract between themselves to reinstate these more primitive methods of trial by combat and to restore to themselves and to each other rights of aggression and defense which had already been forbidden, when the contract was made … ").

10 Our fact pattern is premised upon a dispersed pool of limited partners, so precluding self-nomination will at a minimum reduce and could entirely preclude nominations.

11 Alternatively, if the committee is afforded the capability of hiring consultants and otherwise collecting expert direction, perhaps it would be appropriate to hold them to a fiduciary standard both with respect to who is hired as an expert and the reliance upon the assessment provided.

12 *See* Unif. Ltd. Part. Act (2001) §110(b) (6), 6A U.L.A.378 (2008) ("A partnership agreement may not … unreasonably reduce the duty of care under Section 408(c).").

13 *See* Rev. Unif. Ltd. Part. Act (1985) §1105, 6A U.L.A. 399 (2008).

14 *Contrast* Unif. Ltd. Part. Act (2001) §305(a), 6A U.L.A. 424 (2008) ("A limited partner does not have any fiduciary duty to the limited partnership or to any other partner solely by reason of being a limited partner").

15 *See*, *e.g.*, *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A2d 160 (Del. 2002).

16 *See www.google.com/search?q=Rock+paper+scissors+lizard+Spock&ie=UTF-8&oe=UTF-8&hl=en&client=safari#imgrc=fOCljAyNI4n3aM%253A%3Bundefined%3Bhttp%253A%252F%252Fwww.momsminivan.com%252Frock-paper-spock.jpg%3Bhttp%253A%252F%252Fwww.momsminivan.com%252Frock-paper-scissors-lizard-spock.html%3B493%3B399*; *see also, www.youtube.com/watch?v=x5Q6-wMx-K8&sns=em.*

17 This consideration would apply equally to games of liars poker, flipping a coin, drawing cards, *etc.*