



## OUTSIDE COUNSEL

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### *A 'David, Goliath' Alliance? Ponder Exits, Money Stability*

Sometimes Bible stories don't always cover all the issues, especially in the world of business. Be prepared, because an honest and righteous David cannot always defeat Goliath, when he's your business partner. To come out on top, you're probably going to need more than a slingshot.

It may be trite to say, but before you enter into a business agreement with another party, consider the economic costs that you may have to bear if the deal doesn't work out as planned, as well as the economic benefits that you may enjoy if all goes well. Be prepared for the worst. With that in mind, there are many things to consider as you negotiate and draft the agreements for your next deal.

#### **Plan Escape Hatch**

**1. Consider the creation of escape hatches from the agreement.** Always plan exit ramps from the relationships created in business agreements that are tailored to the specific facts and circumstances of the deal. Arrange things so that those exit ramps can be triggered at specified milestones during the course of the transaction, in case things don't work out as planned along the way. Make certain that you know how to use them, and estimate how expensive it will be and how long it will take to use them.

One example would be a real estate development with one party providing much more capital to support development than the other. The agreement needs to specifically lay out how each side can terminate its involvement and escape further obligations to incur expenses for the ongoing project. The



agreement should also include provisions for a party to recover capital if the project fails to meet identified development milestones.

The parties need to consider a scenario in which the Goliath financial partner wants out of the deal. The parties need to develop a detailed methodology for returning capital investment to the withdrawing partner in a way that both parties can live with. The withdrawing partner should not be able to immediately deplete all the resources of the remaining partner or any separate entity created as part of the transaction. If that were the case, our remaining David would be left at the mercy of Goliath.

At the same time, David needs to consider an exit strategy if Goliath fails to live up to its side of the bargain (such as supplying the ongoing cash). The agreement should address at least two factors: First, it should spell out the economic interests David retains in the transaction, despite its withdrawal under such circumstances. Second, the agreement should address a buy-out option. It should detail a methodology in the event that David wishes to buy Goliath's interest in the project. This buy-out plan should be one that David can realistically afford to pursue given its more limited resources, if the situation arises.

**2. Consider the relative economic strengths of your potential partner in the deal, as well as your own.** The words of a contract, regardless of how well-drafted, can protect you only so far. Always think about the ability to defend your position in a business transaction. Consider the disparity between your resources at the commencement of negotiation: If Goliath chooses to ignore the terms of the deal, and tells David "sue me if you don't like it," David may have a very limited ability to fight back.

#### **Arbitration**

One technique to level the playing field in a dispute and avoid litigation is to require arbitration as a condition of the agreement. Arbitration is a process of dispute resolution that is generally less costly and frequently more expeditious than litigation. Another technique that can be used is a clause requiring all litigation costs to be paid by the loser, including the other side's legal fees. This can make it more costly for Goliath if it chooses not to play by the rules of the agreement. But remember, if David cannot afford to front the ongoing costs of the litigation or cannot find a lawyer to take the case against Goliath on contingency, righteousness will not get David across the finish line. An unscrupulous Goliath can win by wearing David down with financial power and denying David the benefit of the agreement.

So, at the outset of each transaction, parties should consider how they will protect their positions if things go wrong. As the aggrieved party, can you pay the costs of litigating against your partner, given an imbalance between your financial resources? In the final analysis, David's best defense may have been picking a better partner, and there is really no better way to start a business than that.

**3. Consider the economic and financial**

*interests that all partners have in the deal, how they will improve if the deal works out, and how those interests could be protected if the deal goes bad.* Let's go back to David and Goliath: David is very talented in a particular area of business, and the financial Goliath wants to utilize David's talent in a transaction. With David supplying the "sweat" as its only contribution, the agreement allows David to earn a stake in the deal based on its efforts and the use of Goliath's money. David needs to be wary. If the deal that they arrange seems too good to be true, it probably is too good to be true.

A party wants to avoid setting up a scenario that may cause Goliath to regret its decision in agreeing to the terms of the deal. Despite any earlier agreement, Goliath may start to feel David is profiting "unfairly" from the deployment of their resources, even if David is playing by all the rules set forth in the agreement. Goliath's regrets can turn into David's as well. This can occur through no fault of David, other than David's being a good negotiator for its own interests. In this scenario, David may need to be mindful of Goliath's interests at the start of the deal.

If Goliath has the full obligation to support the deal financially, and the costs of that support go up as the result of delays not caused by David, while David's ability to earn its full equity percentage is not affected, Goliath's natural tendency to protect its interests, regardless of what is provided in the agreement, may come to the fore. Goliath may attempt to change the deal to recoup its losses out of David's interest as a result of "an unanticipated change of circumstances" or a sense of "fairness." If David doesn't agree—well, we're back to some of our earlier scenarios.

To avoid this scenario, David might be better off leaving something on the table for Goliath if any unanticipated changes should occur resulting in losses to Goliath. Perhaps David could agree to pick up a share of Goliath's increased costs with a reduction in David's ultimate equity percentage. Some recognition of Goliath's pain, and a willingness to share it to the extent possible given the discrepancy in financial resources, could go a long way to keep Goliath from "unfairly" using the weight of its greater financial resources against David.

**4. Consider the historic interests and abilities of the parties in the transaction.** If the parties that are supposedly aligned with you at the outset have a natural affinity for the party on the other side, whether personally or in the ability to benefit financially from associations

outside the scope of the present deal, consider how you will defend yourself in regard to a realignment of the parties. In this case, we don't need to have parties of disparate financial resources to create a problem.

### **Development Scenario**

Let's go back again to our real estate development scenario. Let's assume that one of the parties in the development is strictly a financial partner. Let's also assume that the other parties approach this transaction together, and have worked together before, with each of the parties having a different role to play in the development (e.g., one is to provide construction services and the other is to provide development acumen). Together they provide an informal counterweight to the financial partner in the management of the development.

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In this case, it might be wise to "formalize" the relationship among the "counterweight" parties with respect to the way that they will make management decisions on the project. That way, if things don't work out as planned for the financial partner, or if the financial partner thinks that the deal is working out "too well" for one of the other partners, the financial partner may use the promise of future lucrative transactions to separate the counterweight partners from each other, unless "fairness" is restored. Without a formal agreement to use their power together to achieve management solidarity, a financial partner may be able to turn one partner against the interests of the others, in return for the prospect of future gain provided by the powerful financial partner.

For example, if the need to add additional capital to the venture can be effected in

more than one way (i.e., the financial partner is responsible for funding a higher percentage of the additional capital if the need is characterized by the partners in a certain way), and a majority vote of the partners is necessary to determine under what terms that capital is added, an issue arises: The power of the financial partner to influence the vote of other partners, based on its ability to provide financial incentives that are unrelated to and outside of the project itself, is always present. To protect against this possibility, it is wise to enter into a separate agreement among the counterweight partners that provides for a coordinated approach to management and other issues that may arise. Such an agreement can blunt the financial partner's ability to cause a rift between the counterweight partners for the financial partner's gain with a lucrative deal offered as an incentive to make a counterweight partner change sides.

### **'Never Fall in Love'**

The practical advice here is that you should never fall in love with a transaction, any transaction. Love is for wives, children and pets, not for business deals. Consider walking away from a transaction in which the matters of vulnerability raised here are at issue, when you can't negotiate sufficient protections or defenses against them. When considering whether or not to enter into a business deal, look for partners with whom either your relative economic or financial capabilities and strengths are matched, or your historic relationships have been previously tested or are otherwise secure.

Always remember that the written words of a contract can take you only so far: If the party on the other side of the contract is of an attitude to shoot first and consider the language of the contract later, or if the party—in the event it takes an action—has the unfair advantage of more financial capability to fight for a prize than you, then consider strongly whether this is the right party with which to enter into a contractual relationship, and if the deal is really right for you.

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