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German Tax and Legal News

Russian Roulette and Texas Shoot-Out Clauses as elements of JV or Shareholder Agreements

How thoughtful drafting of agreements can help in avoiding and overcoming shareholder disputes.

Shareholder disputes can jeopardize the continued existence of companies, especially in the case of 50/50 joint ventures. Below you will find an overview of corporate law instruments for avoiding or overcoming the dreaded deadlock situations.

Persistent shareholder disputes can pose a threat to the smooth conduct of business and the continued existence of companies. This is all the more true if it concerns two-person companies in which the shareholders have an equal share, since particularly in such constellations blockade or stalemate situations, so-called "deadlocks", which endanger the company, can occur.

If the proverbial "horse has already left the barn" and a dispute between shareholders is gathering speed, the resolution of the conflict is usually costly and the outcome uncertain unless the articles of association and other agreements provide for suitable regulations.

In order to avoid or overcome deadlocks, clauses have been developed in American contractual practice which are intended to enable a shareholder to quickly exit the company, provided that the other shareholder takes over his shareholding.

Such termination clauses are also used in the German contractual practice, but their effectiveness has been disputed for a long time. The case law of the Federal Court of Justice (judgment of 19 September 2005 - II ZR 173/04) regularly argued in favour of the invalidity of termination clauses which were intended to make it possible to exclude a shareholder from the company even without objective reason.

The decisive consideration for the invalidity of termination clauses is to protect the shareholder threatened by the exclusion or termination. Finally, the free right of termination of the other part could be perceived as a means of discipline. In the worst case, out of concern that he would be at the mercy of the arbitrariness of the shareholder entitled to exclusion, he would not make free use of his membership rights or not comply with his shareholder obligations, but rather bow to the ideas of the other side, since the right of termination always hanging over him like a "sword of Damocles".

At the latest with the decision of the Higher Regional Court of Nuremberg of 20 December 2013 - 12 U 49/13, however, a court of higher instance confirmed the fundamental admissibility of so-called "Russian roulette" clauses, since - according to the court – these clauses are not intended to provide the possibility of excluding a shareholder without objective reason, but rather are primarily intended to serve the dissolution of deadlocks which endanger the continued existence of the company.

In the following, the functionalities of the common termination clauses as well as the requirements for their effectiveness will be presented in an overview.

1) Russian roulette clause
First to the terminology: The term "Russian roulette clause" is common, but not mandatory. For example, in the case to be decided by the Higher Regional Court of Nuremberg, the clause was referred to as the "Chinese clause". Nevertheless, the general term "Russian Roulette Clause" in case law generally covers clauses which attempt to resolve a shareholder conflict in two-person companies by withdrawing a shareholder according to the following basic idea:

- Each shareholder has the right to offer his shares in the company to the other party for purchase at a specified price.
- If the other shareholder receives such an offer, he has the choice: Either he accepts the offer and becomes the sole shareholder against payment of the price demanded by his co-shareholder or he sells his shareholding to the offeror/co-shareholder at the

same, binding price.

The main advantage of such a clause is that it allows a deadlock to be resolved quickly and easily. A major disadvantage, on the other hand, is the associated risk of a rapid loss of shareholder status.

Since the price offered can be both the selling price for the shares held by the shareholder initiating the process and the purchase price of the co-shareholder's shares, the price should ideally be reasonable, but ultimately the outcome may depend on chance or on which shareholder offers his shares/participation more quickly. In contractual practice, such clauses are arbitrarily extended, for example by agreeing on a time limit for acceptance and/or a penalty deduction in the event of failure to comply with the time limit.

2) Texas Shoot-Out Clause
The Texas Shoot-Out clause is a further development of the Russian Roulette clause, which works according to the following pattern:

- Each shareholder is entitled to make an offer for the other shareholder's shares in the company by quoting a certain price.
- The other shareholder can accept the offer or he can submit a higher offer to the offeror for the purchase of his shares in the company. The bid changes back and forth until the "auction" ends with the highest bid.

A large number of different variants or combinations are conceivable. Another variant encountered in practice is, for example, the (reverse) case in which the shareholder offering first does not make an offer to purchase the other part's stake in the company, but offers the other part - as in the basic model of the Russian Roulette clause - to buy its own shares. The other shareholder then has the choice of accepting the offer or again submitting an offer to acquire his own shares. In this variant, the offer also changes back and forth and ends with the highest bid.

3) Risk of abuse of shoot-out clauses in general
Common to all shoot-out clauses is the risk that a deadlock may be abusively induced by a shareholder to trigger the shoot-out mechanism. It is conceivable, for example, that one shareholder would like to use the existence of a deadlock to put the other shareholder under pressure. Under which circumstances an abusive causation of a deadlock is to be presumed shall be determined on a case-by-case basis. At the same time, the existence of an abusive causation is likely to be difficult to prove, since no shareholder can be compelled within the framework of his duty of loyalty to support a decision that contradicts his comprehensible economic interests.

Furthermore, there is the risk that in the event of a deadlock - irrespective of whether or not it has been abused - the situation that has arisen or the provisions of the articles of association will be exploited to the detriment of a shareholder. This is the case, for example, if one shareholder is aware of liquidity difficulties of the other shareholder and exploits this to acquire his shares at a favourable price, for example by setting a (too) low purchase price for the acquisition of the participation.

4) Practical note: requirements for validity and enforceability
In its decision, the Higher Regional Court of Nuremberg clarified that clauses of the type described herein are not permissible without limitations.

Concerns about admissibility may arise in individual cases, for example, if one of the two shareholders is unable to finance an acquisition offer from the outset and the enforcement mechanism of the shoot-out procedure, which is detrimental to him, must therefore be avoided as far as possible.

However, the risk of abuse of shoot-out clauses, which always exists in principle, should not lead to their general invalidity.

If a party does not wish to expose itself to the risk associated with such clauses, it should - according to the Higher Regional Court of Nuremberg - not engage in such proceedings and should not agree on a shoot-out clause with the co-shareholder. According to the decision of the Nuremberg Higher Regional Court, a subsequent financial imbalance is unlikely to lead to ineffectiveness.

In order to avoid disputes about whether or not the shoot-out mechanism intervenes, it is advisable to clearly define when a deadlock exists and in what kind of deadlock a shoot-out mechanism should kick in. This may be the case, for example, if there is a stalemate with respect to a material, contractually defined issue of corporate governance.

The shareholders should regularly have no interest in small, insignificant differences of opinion triggering the shoot-out mechanism, which is often understood as a last resort.

Sufficiently long deadlines should also be granted, which allow a shareholder, for example, to secure outside financing for the acquisition of the shareholding. In order to counter the risk of abuse and, above all, the possible invalidity of the clause, it is also advisable to agree that the purchase price determined by the shoot-out clause may not fall below the book value.

5) Summary

Shoot-out clauses in articles of association can be a proven and effective means of resolving deadlocks. The very existence of such a clause in shareholder agreements and articles of association creates a potential threat that can certainly have a disciplining effect in that the shareholders reconsider their own position with regard to the position in conflict.

However, the risk of abuse associated with such clauses should not be underestimated, which can occur particularly with economically unbalanced partners. This risk can at least be reduced by appropriate contract design. The wide range of variation and design possibilities of shoot-out clauses allows shareholders to find tailor-made solutions in the event of a conflict - however, it is advisable to provide forward-looking and professional advice on corporate law.