DEFINING A JOINT VENTURE'S SCOPE OF BUSINESS: KEY ISSUES TO CONSIDER

To Our Clients and Friends:

Early in the discussions about whether and how to form a joint venture[1] -- perhaps as the very first significant issue to be resolved -- the potential joint venture partners[2] will try to agree on the scope of the venture's business. That definition is usually embodied in one or more of the venture agreements, and may circumscribe the nature of the venture's business, potential future lines of business into which the venture may expand, geographic areas in which the venture will or may operate, and how deviations from the venture's scope will be determined and approved by the venture partners.

As partners negotiate the scope of the venture's business, they also need to focus on the key corollary provisions of the venture arrangement impacted by the agreed-upon scope. The terms of those provisions will in turn inform the discussion about scope. This alert focuses on factors to be considered as the venture partners discuss two of the core issues that arise in conjunction with the discussion about scope: the parameters of the non-compete, if any, to be entered into by the partners for the benefit of the venture, and the application of the corporate opportunity doctrine to the venture and the venture partners.

The Non-Compete Conundrum

Most venture partners will request that a non-compete provision prohibit any venture partner from competing with the venture.[3] Unless the venture is able to operate as a successful standalone business from its inception, and the joint venture partners have no competitive lines of business or plans to develop such lines of business -- an unlikely scenario -- potential venture partners will often expect the partners to agree to a non-compete. A non-compete provision protects the venture business and gives it time to become successful. It can also ensure that the venture partners are committed to the business and its success, and that, as business decisions arise, the venture partners' interests are aligned both with each other and with the venture's interests. In addition, a non-compete may be particularly important if the venture's core business uses non-cash assets contributed by the partners (e.g., intellectual property rights). The non-contributing partners will want to ensure that the venture holds exclusive rights to use the contributed assets in the venture's core business (i.e., that the contributing partners have not retained rights to use those assets to compete with the venture).[4] A failure or refusal to agree to a reasonable non-compete provision is frequently an early signal that the venture partners are not aligned, or that they are not committed to the venture.[5]

At the same time, it is not in the best interest of the venture (or of the venturers) to have an overly broad or inflexible non-compete provision. A venture that is asked to agree to a broad non-compete or to a non-compete that will restrict growth in its core business may either decline to join the venture, or require provisions that limit the protection afforded to the venture by the non-compete, e.g., provisions that limit the period the non-compete is in effect while a partner is a member of, or after the
partner has exited, the venture or otherwise cause the non-compete provision to cease to apply. The ideal non-compete will balance the need to protect the venture's core business and an individual venturer's desire to curb the restrictions imposed on its activities outside of the venture. A non-compete that provides fulsome scope protection by defining the venture's business very broadly may be achieved at the price of duration or other limitations.

As venture partners negotiate the terms of a non-compete provision, they should take into consideration the following issues and objectives:

The non-compete should not be broader than the agreed-upon scope of the business of the venture and in many cases can be narrower. A classic non-compete provision will prohibit the venture partners from competing in the "business" of the venture, as defined in the venture agreements. That type of provision, however, may mean that the venture partners try to narrowly define the scope of the business in order to limit the scope of the non-compete. Alternatively, the venture partners can purposely choose to have a non-compete that is narrower than the defined "business" of the venture. For example, the non-compete might encompass only the "core" portions of the venture business or the portions of the business where competition would be most problematic. If a venture's intended business is to manufacture specialty tools and to sell them directly as well as through distributors, it may be in the venture's interest to permit its partners to sell the tools as well. A classic non-compete could therefore be adapted to this situation to apply just to the manufacturing component of the venture's business. Additionally, in this example, permitting the partners to engage in "competing" activities (the sale of tools) could both align their interests with the advancement of the venture's manufacturing business and help the overall venture business succeed by providing additional sales outlets.

*The non-compete should take into account potential changes in the venture's business.* As any business grows, it is likely to enter into new areas of endeavor. Any non-compete provision therefore needs to clearly state whether and how the expansion of the venture's business will impact the non-compete provision. Changes to the scope of the venture's business as defined in the venture agreements often require the approval of the venture partners. If the non-compete covers all business conducted by the venture rather than one or more specific lines of business, the venture partners may avoid expanding the venture's business to avoid being restricted by a broader non-compete provision. Note that in instances where the expansion of the venture's business will in turn expand the non-compete provision, it is more likely that the venture agreements will require that the partners approve the changes, and may even require that such changes be approved by a unanimous or super-majority vote.

*The non-compete should take into account potential changes in the venture partners' businesses.* Just as the venture's business is unlikely to be static, the venture partners' respective businesses will likely change over time. A partner that is concerned that its current or future plans to expand its core business will be thwarted by non-compete obligations to a joint venture is unlikely to agree to a non-compete. As a result, it is in the best interests of the partners and the venture to anticipate and expressly deal with potential changes to a partner's business that could cause it, unintentionally, incidentally or immaterially, to breach a non-
compete provision. Common exceptions to non-compete provisions include passive minority investments in competing businesses (e.g., a partner may hold less than X% of the outstanding securities of a competing business, as long as the partner does not have a representative on the board of, or otherwise control, the competitor). Less common but not infrequent exceptions permit a partner to acquire a competing business within stated parameters. For example, exceptions may permit the acquisition of a competing business if the competing business is not the primary business acquired,[6] if the competing business is disposed of within a specified period of time after the acquisition (which may be coupled with a requirement that the competing business first be offered to the venture) or if the competing business is first offered to the venture and the venture declines to pursue such opportunity before the venture partner acquires it.[7]

*The entities bound by the non-compete should be carefully defined.* Venture partners will negotiate not just the activities restricted by a non-compete, but also the persons that are bound by the non-compete. In addition to the venture partner and entities within its control, e.g., its subsidiaries, broader non-competes may apply to entities or persons the venture partner may not necessarily be able to control, such as the venture partner's parent companies and/or its affiliates. Frequently, venture partners are entities within a multi-entity structure. The larger and more complex its organizational structure, the harder it will be for a venture partner to agree to constrain all of its affiliates. For example, a venture partner may be affiliated with one or more public companies (e.g., one of the owners of the venture partner may also own more than Y% of the equity of a public company, or one of the venture partner's directors may also serve as a director of a public company). Binding a venture partner's public company affiliates, or the affiliates of a public company venture partner, is not generally possible. In such circumstances, the parties should consider whether the non-compete can be effective if affiliates cannot be bound and whether there are other protections that should be implemented in addition to or instead of a non-compete. For example, if the venture partner itself is bound by the non-compete, the venture agreement can specify that the venture partner's officers and directors may not be affiliated with any other entity whose operations would violate the non-compete (if such entity were bound by the non-compete) and that the venture's information cannot be provided to any of the venture partner's affiliates engaged in competing businesses.[8]

Finally, if any non-compete provision is to be incorporated into the venture agreements, antitrust counsel should be involved early in the discussions, as non-competes frequently raise competition law issues. (Note in particular that care should be taken to analyze any potential antitrust issues in each jurisdiction in which the venture will operate.)

**Whose Opportunity Is It Anyway?**

The managers[9] of a venture will have a duty of loyalty to the entity unless that duty can be (and is) expressly waived.[10] If a duty of loyalty applies, managers appointed by or otherwise affiliated with a venture partner will be prohibited from diverting business opportunities from the venture -- frequently referred to as the diversion of a "corporate opportunity"[11] -- although we refer to it below simply as the "opportunity doctrine."
This opportunity doctrine can interfere with the ability of the venture and the venture partners to develop new businesses, especially if the activities of the venture and the partners are closely related. If a partner's employee serves on the venture's board of managers and learns of an opportunity to acquire a successful business while acting in the capacity of a manager, the manager/employee may be barred by his/her fiduciary duties to the venture from describing this opportunity to the partner, even though the manager may also owe fiduciary duties to the partner (e.g., if the employee is also an officer of the partner). Even more difficult issues may arise if a manager obtains information about a new opportunity and it is not clear whether that information was provided to the manager in his/her capacity as manager of the venture, or as an employee of a partner.

While the courts have developed several tests to determine whether the opportunity doctrine bars exploitation of a particular business opportunity by a fiduciary, there are few bright-line guidelines for fiduciaries, partners or ventures to follow to determine when an opportunity problem is present or how to sanction the pursuit of such opportunities by partners. For these reasons, venture partners will often seek to address these problems contractually, at the time the venture is formed, by either explicitly waiving the opportunity obligation or by defining and limiting its scope.

As the venture partners discuss provisions defining the obligations of partners and their representatives to inform the venture of opportunities, they should consider the following issues. To the extent the partners expressly agree to limit the scope of the opportunity doctrine, that waiver should be expressly stated and the scope of that waiver expressly described.

**Define the scope and applicability of the opportunities provision carefully**

*What is the scope of the venture's business for purposes of the opportunity doctrine? Stated another way, what opportunities are the partners interested in pursuing through the venture?* Similar to non-compete provisions, provisions dictating what opportunities a partner or its representative must disclose to the venture are highly dependent on the definition of the scope of the venture's core business. In the context of opportunity provisions, it is particularly important for partners to define permitted activities -- such as the businesses already conducted by the venture partners outside the scope of the venture -- so that these provisions do not operate to increase the scope of the venture's business and encroach upon the businesses of its partners. Defining the scope of the venture's business is not generally enough, however, to prevent issues from arising. Once the partners agree on the types and nature of opportunities that must be presented to the venture, they should expressly relieve the partners and their representatives from any obligation to bring other opportunities to the venture, as well as any obligation to advise the other partners of such opportunities or to permit other partners to participate in them.

*Who is obligated to bring an opportunity to the venture? Does the manner in which such persons become aware of the opportunity or the nature of the opportunity affect whether it must be presented?* When determining whether a party should have presented an opportunity to a venture, courts often consider the source of the opportunity and the context in which the party learned of the opportunity. Venture partners should also consider these factors when defining the parameters of opportunities required to be brought to the venture. For example,
partners could clearly state in the venture documents that a partner is only obligated to disclose to the venture opportunities discovered by partner employees who are also managers of the venture and that a partner has no obligation to disclose opportunities that are initially discovered by any of the partner's other employees. An additional express limitation on a partner's obligations could provide that even opportunities of which a manager of the venture is aware do not have to be presented to the venture unless the manager learned of the opportunity in his or her capacity as such. It may not always be possible, however, to determine in what capacity an individual learns of an opportunity, or practicable to expect that knowledge of particular opportunities can be confined to certain individuals. As a result, the venture partners should also consider using different or additional parameters to describe the opportunities that must be presented to the venture, e.g., opportunities to acquire real property located in a specific area or opportunities to enter specified markets. As a general rule, the more narrowly the scope of the venture's business is defined, the easier it will be to identify or describe the opportunities that must be presented to the venture. Lastly, the partners may want to agree that certain opportunities, even if they are within the scope of the venture's business, are not required to be presented to the venture. Opportunities which could expressly be waived might also include those which the venture could not reasonably take advantage of (for example, an opportunity requiring more than a certain amount of capital, or an opportunity that would require operations outside the geographic areas in which the venture is engaged in business).

Create a clear process and timeline for the venture to consider the opportunity

If the opportunity doctrine is not completely waived, it is useful to describe in advance what process should apply if an opportunity is presented to the venture.

Disclosure and consent. Many opportunity provisions permit a fiduciary to pursue a business opportunity on its own behalf after all material information concerning the opportunity has been disclosed to the venture, and after the venture, acting through a disinterested person with decision-making authority, grants express permission to the fiduciary to proceed.[14] However, disclosure and consent is not a perfect remedy and raises a few other problems.

• Problem #1 -- Conflicting Disclosure Obligations. A fiduciary of the venture may find himself or herself in a position in which he or she has conflicting obligations; for example, if that person serves both as a manager of the venture and as an officer of a partner. In that situation, if the manager-officer discloses a new opportunity to both parties and both parties express an interest in the opportunity, the fiduciary cannot proceed without breaching a duty of loyalty to either the venture or the partner. The fiduciary may face yet another conflict if the terms under which the fiduciary first learned of the opportunity prevent disclosure of the opportunity to another party; for example, a confidentiality or exclusivity agreement with a target company may restrict the fiduciary's ability to disclose or discuss the acquisition opportunity with any other person.[15] A common approach to this problem is to explicitly permit a partner (and managers appointed by such partner) to withhold information from the venture that is subject to conflicting confidentiality or fiduciary duties. The difficulty lies in defining which such duties exonerate the partner from its duties to the venture: Fiduciary duties to the partner's owners? To other ventures?
Contractual confidentiality obligations owed to third parties? In any case, what if such duties were created well after initial formation of the venture?

- **Problem #2 -- Venture's Inability to Act Without the Presenting Partner's Consent.** A venture may be unable to act upon an opportunity without the action or consent of the partner that discovered and presented the opportunity. Such partner's consent may be required for operational reasons (e.g., in order to deviate from the venture's current business or to make a capital expenditure outside an approved budget), financial reasons (e.g., to raise the capital to make such investment) or other extra-contractual reasons (e.g., to preserve peace within the venture). Of course, the presenting partner may have its own designs on pursuing the opportunity independently. In anticipation of such contingencies, a venture agreement may include provisions that: (a) require the presenting partner to act in accordance with applicable fiduciary duties (if any) or pursuant to some other standard (e.g., good faith) while considering any actions or consents required to pursue such opportunity; (b) permit the presenting partner to pursue the opportunity if the venture is unable or unwilling to pursue the opportunity, but require that the presenting partner provide either the venture itself or the other venture partners, individually, with the opportunity to participate in such opportunity (e.g., a right of first refusal to provide any capital raised to pursue such opportunity); or (c) in certain situations, forbid a partner from pursuing an opportunity, even after disclosure of such opportunity to the venture.

- **Problem #3 -- Scope of Opportunities Subject to Disclosure Obligation.** Some opportunities may be clearly outside the scope of the opportunities doctrine obligation (e.g., because the venture documents specifically exempt such opportunities from the disclosure obligation) and therefore may be pursued by a venture partner without prior disclosure to the venture. In many instances, however, it won't be clear whether the opportunity in question is subject to the opportunities doctrine. For example, an opportunity may involve the acquisition of another company with several lines of business, only one of which falls within the scope of the venture's business. In order to avoid after-the-fact disputes, some ventures require partners to notify the venture of **any** opportunity they wish to pursue -- regardless of whether it is within the scope of a partner's opportunity obligations. Of course, such an obligation could place significant burdens on a venture partner that is actively pursuing opportunities, and should therefore be used only after careful analysis and on a case by case basis.

**Other procedural concerns**

*Establish a clear procedure for the venture to follow when considering the opportunity.* Procedures for presenting an opportunity to a venture will likely include: how long the venture will have to review an opportunity, what information must be shared between venture partners and the venture itself, when the venture must render a decision, who will decide whether the venture will pursue the opportunity and, if the venture chooses to pass, how long a venture partner will have to consummate such opportunity (taking into account any third-party or regulatory approvals).
If the venture pursues the opportunity, create a clear process for the venture to negotiate the opportunity with any relevant third party. Certain opportunities will challenge the efficacy and appropriateness of the decision-making processes established for the venture. For example, in a 50/50 venture, the venture documents may require that representatives of both partners be involved in negotiations of significant transactions. This approach may not be ideal if one venture partner is also interested in pursuing the subject transaction due to the conflicts of interest such partner's representatives will face when negotiating on behalf of the venture. It is difficult to anticipate all of the various ways an opportunity could upset the delicate internal balance of controls, particularly as during negotiations of the opportunity, each partner's competing concerns may pull the venture's negotiations with third parties in contradictory directions. Partners may, however, specifically agree in advance which partner will negotiate the terms and conditions of particular transactions on behalf of the venture (e.g., provide the lead to the partner that does not have a conflict of interest or, if all partners have such conflicts, provide the lead to the partner investing the most capital required to pursue such opportunity).

Address how the ability to pursue an opportunity fits with the non-compete provision, if any. Even though a partner may be permitted to pursue an opportunity after its presentation to the venture, the venture may still have concerns that such partner's attention would be diverted from the venture's business in favor of the new opportunity, or that the partner, after developing the opportunity, could compete with the venture. For such reasons, the venture may impose restrictions on a partner's participation in an opportunity, including the aggregate amount that a partner may invest in an opportunity, the percentage of equity a partner may hold in such opportunity, or the amount of time a partner may dedicate to such opportunity. All such restrictions should dovetail neatly with the venture's non-compete provisions, if any.

Summary

As in any complicated commercial arrangement, the discussion of one provision in a venture agreement, namely the scope of the venture's business, will inevitably flow into and inform a discussion of other issues. Negotiators of a potential venture need to be sensitive to the non-compete and opportunity doctrine issues that will arise once the venture's scope of business is defined. Ideally, they will have a view about how they want to address those issues and be prepared to raise them in the initial discussion about the scope of business.

[1] Joint ventures can be organized in a variety of ways; the venture partners can form a new entity that will conduct the venture's business, or the venture partners can enter into contractual arrangements pursuant to which they will conduct the venture's business directly. Venture partners that elect to form a new entity can select from several different entity structures, including limited liability companies, or "LLCs," partnerships or corporations. For purposes of this note, we do not detail how the concepts discussed would vary depending on how the venture is structured, but readers should be aware that there are nuances that vary depending on the type of joint venture structure and that are not outlined below.
[2] We use the terms "partners," "venturers" and "venture partners" throughout, although, as noted in footnote 1, the joint venture entity may not be a partnership, but instead may be organized as an LLC, corporation, etc.

[3] The partners may also require that the venture not compete in certain areas in which the partners operate, although such a limitation can be effected by circumscribing the scope of the venture's business (see below).

[4] This result can sometimes be obtained through other means (e.g., the contributing partner can restrict the use of intellectual property rights contributed to the joint venture by granting the joint venture an exclusive license of such intellectual property in a specified field).

[5] There are situations where one or more of the partners will not expect the joint venture arrangements to include covenants not to compete, and will reasonably resist them. For example, if some or all of the partners are already engaged in a competing business, they may agree that the venture documents will not include a non-compete, or they may agree to a limited non-compete that includes a carveout for existing businesses (including ordinary course expansions of those businesses, including into related areas). If one partner is joining the venture for strategic reasons, and other partners are financial investors, the strategic partner may resist the requirement that it agree to a non-compete if the other venture partners will not be similarly affected (because they are not directly engaged in the venture business). Alternatively, the partners may negotiate non-competes that are tailored to each partner; e.g., the strategic partner may agree not to engage in a business that competes with the venture and the financial investors may agree not to provide financial support to businesses that compete with the venture.

[6] Whether a business is the primary business acquired may be determined by comparing the revenues earned by the competing business with the revenues earned by all of the acquired businesses.

[7] See the discussion of the opportunity doctrine below.

[8] This type of provision may be required in any event for antitrust reasons.

[9] We use the term "managers" to describe the persons who are directors or the non-corporate equivalent (e.g., managers or general partners) of the joint venture.

[10] In a Delaware LLC, a manager is subject to the fiduciary duties of loyalty and care unless the LLC agreement explicitly expands, restricts or eliminates such fiduciary duties. Del. Code Ann. tit. 6, § 18-1101 (c) (West 2010) ("To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing."). See also Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839 (Del. Ch. 2012).

[12] Delaware courts apply the line of business test, under which fiduciaries are precluded from pursuing an opportunity if it falls within the venture's line of business and if the venture has the financial ability to develop the opportunity. See Thorpe v. Cerbco, Inc., 676 A.2d 436, 441–42 (Del. 1996) (citing Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939)). In Thorpe, the court stated that the Guth court examined several elements in applying the opportunity doctrine: "[I]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, [and it is], from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize such opportunity."

Some of the cases also take the position that the line of business test prevents a fiduciary from using an opportunity in which the corporation has an "interest"; for example, if the venture’s assets were used to develop the opportunity or if the opportunity first came to the fiduciary's attention when he or she was acting in his or her corporate, rather than individual, capacity. See Schreiber v. Bryan, 396 A.2d 512, 518-19 (Del. Ch. 1978).

[13] The Delaware courts have suggested that corporate joint ventures deal with opportunity problems in advance by addressing them in the charter. In U.S. West, Inc. v. Time Warner, Inc., the Delaware Chancery Court said that "the treatment of 'corporate' opportunities by a managing person or entity (or person controlling one) is a rather prominent candidate for explicit contracting in this age of limited partnerships and corporate joint ventures." Civ. A. No. 14555, 1996 WL 307445, at *23 (Del. Ch. June 6, 1996). The court also said "there is no reason why corporate charters cannot contain provisions dealing with corporate opportunities or dealing with the ability of officers or directors to compete with the corporation." Id. at *22. In Kahn v. Icahn, the court applied similar principles in the partnership context. No. Civ. A. 15916, 1998 WL 832629 (Del. Ch. Nov. 12, 1998). In that case, which involved the potential usurpation of a partnership opportunity, the court said that traditional fiduciary duties are default duties that may be modified in the partnership agreement, and that partnership agreements may act as safe harbors for partners' actions that may otherwise violate traditional fiduciary duties.

[14] For example, the Seventh Circuit addressed the issue in McCabe Packing Co. v. United States, 809 F. Supp. 614, 617 (C.D. Ill. 1992). Similarly, the Supreme Court of Delaware ruled on such a provision in Kaplan v. Fenton, 278 A.2d 834, 836 (Del. 1971).

[15] A partner may also resist disclosing opportunities that it wants to pursue if the partner is concerned that the other venture partners, upon learning of the opportunity, will also want to pursue the opportunity individually.
Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you work, the authors (Ruth E. Fisher and Benyamin S. Ross), any of the following, or any member of the firm's Corporate Transactions Practice Group:

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