Planning for a Successful Joint Venture

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Professional Profile

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• Advises companies on:
  • mergers and acquisitions
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Professional Profile

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• Practice focuses on:
  • mergers and acquisitions and private equity transactions
  • joint ventures and strategic partnerships
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1. Introduction
Introduction

• Our goals today are to:
  – Discuss why negotiating joint ventures can be harder than M&A transactions and why term sheets are more useful than in M&A deals
  – Focus on some of the issues most likely to cause friction in a joint venture negotiation:
    • Scope of the venture
    • Governance issues
    • Resolving deadlocks
    • Exit provisions
    • Issues arising when the venture and partners share assets
2. Getting Started
Getting Started – Why is it so hard?

Negotiating and drafting joint ventures is very challenging:
• Often more difficult than negotiating and drafting an acquisition agreement.
• Joint ventures contemplate ongoing business relationships, not a one-time transaction
  – Relationship must be durable and flexible to allow for change as business plans, market conditions and other factors evolve
• No such thing as a standard “off-the-shelf” deal
• Few “market” terms
• Lots of tricky issues that can be resolved in many different ways depending on partners’ goals, leverage, etc.
• Partners have to predict the future, e.g., the venture’s future funding needs
• Challenges are getting harder, not easier
Getting Started – Term Sheets & Letters of Intent

Given the complexity in drafting and negotiating joint ventures, partners should strongly consider starting with a term sheet or letter of intent.

• Advantages of term sheets and LOIs include:
  – Helps impose order on a complex discussion
  – Focuses business people on critical choices
  – Confirm agreements on fundamental issues
  – Select issues to focus on initially and defer thornier issues until later
  – Gives lawyers better guidance for drafting agreements
  – Working together to outline the venture may promote success
    • Partners feel committed to the project and one another sooner
  – May be able to file HSR notice using term sheet / LOI
Getting Started – Joint Venture Formation Agreements

Joint venture formation agreements are another useful tool.

• Becoming more common
• Can be used in a variety of ways:
  – Develop a plan for the joint venture with more detail than a term sheet or LOI
  – Roadmap for formation of the venture including timelines for negotiating deal agreements, obtaining required consents, contributing assets and closing
  – List conditions to closing and describe closing mechanics
  – Can keep certain provisions separate from the governance documents, e.g., representations & warranties and indemnification
3. Defining the Scope of the Joint Venture
Defining the Scope of the Joint Venture

- Typically heavily negotiated.

Negotiations are complex partly because partners must consider other key provisions:

- Defines the nature of the venture’s business.
- May restrict types of business the venture may conduct.
- May limit geographic areas in which the venture operates.

- Non-competition provisions.
- Application of the corporate opportunity doctrine.

Changes to the scope often require higher level of board and/or partner approval.

- Each partner may have the right to veto proposed changes to the scope of the joint venture.
4. Typical Governance Structures
Typical Governance Structures – Common Approaches and Issues

50/50 Joint Venture

• Management is responsible for day-to-day operations
• Governing board oversees management
  – Each partner appoints the same number of members to board (or has equal voting rights)
  – Members are removed and replaced by the partner that appointed them
• Specified actions require board approval, including board member(s) appointed by each partner
• Partners have separate voting rights as equity holders
  – E.g., capital calls beyond a cap or fundamental actions such as changes in the venture’s scope must be approved by both partners
• One or more deadlock resolution mechanisms, such as buy-sell mechanism
Typical Governance Structures – Common Approaches and Issues

Venture with a Majority Partner and one or more Minority Partners

• Management is responsible for day-to-day operations
• Governing board oversees management
  – Majority partner appoints a majority of the board
  – Members are removed & replaced by the partner that appointed them
• Specified actions require board approval; shorter list of actions may require approval of minority partners’ board representatives
• Partners have separate voting rights
  – Supermajority voting requirements can be used to give minority partners veto rights
  – List of matters requiring board approval (or supermajority approval) likely to be shorter than in 50/50 deal
• One or more deadlock resolution mechanisms
Typical Governance Structures - Considerations

Partners using one of the typical joint venture governance structures should consider the following:

• Board and partners’ approval rights may overlap. Venture documents do not always clearly indicate if board or partner approval (or both) is required

• Consider limiting the number of matters partners must approve
  – Avoids delay
  – Fewer opportunities for partners with veto power to extract concessions

• Consider if there is a role for:
  – independent directors
  – board committees
  – advisory boards
  – third party deadlock “arbitrator”

• Consider the impact of fiduciary obligations on board decision-making
5. Governance Issues – Governing Boards & Management
Governance Issues – Board Fiduciary Duties

Board members’ fiduciary obligations will impact board decision-making.
- Unless otherwise agreed, board members *may* have fiduciary obligations to all partners, not just the partner who appointed them
  - A partner may expect its board representatives to act exclusively in the partner’s interest. Unless fiduciary duties are waived, the board *may be obligated to* act in the best interest of *all* partners
- Partners should consider whether to waive all fiduciary obligations of the board
  - Board members must still act in good faith
  - Limited waivers of certain fiduciary duties may be an option
- Certain issues may be avoided by giving partners direct decision-making authority
Governance Issues – Independent Board Members

Independent board members can play a role in joint ventures.

• More common in larger and multi-member ventures
• Appointing independent board members can:
  – Offer an independent perspective that may help resolve conflicts among partners
  – Provide special expertise partners may not have
  – In multi-partner ventures, represent the collective interests of partners that do not appoint their own board representatives
  – Elevate the stature or credibility of the venture by appointing industry experts or other prominent persons to the board
Governance Issues – Board Committees

Board committees are being used more and more often.

• Committees often facilitate careful, focused decision-making
• In many cases, committees are analogous to committees a public company board establishes – compensation, governance and audit
• Other committees can facilitate decision-making generally, such as executive committees, or in particular areas, such as technology committees
• Committees can add unnecessary complexity
  – Will using committees be consistent with voting requirements that board representatives of some or all the partners approve particular decisions?
Governance Issues – Advisory Boards

Many ventures are establishing advisory boards.

- Advisory boards enable partners to obtain expertise they lack, *e.g.*, in industry, technical or financial matters.
- Allow partners to allocate fact-finding, community outreach or decision-making responsibility.
- Advisory board members may be independent or affiliates of partners.
- May be purely advisory or it may have authority to make certain decisions.
- Outside advisory board members often request compensation.
  - Will advisory board members receive equity in the venture? A profits interest (if the venture is an LLC)? cash?
- Need to be clear on whether the advisory board activities are covered by insurance.
Governance Issues – Management Team

Partners want to play a significant role in selecting venture management.
• Power to select day-to-day managers of the venture is critical

Partners are experimenting with alternative arrangements to select key officers:
• Each partner appoints a CEO and the co-CEOs serve simultaneous or overlapping terms
• Partners take turns appointing the CEO, who serves for a stated term
• Each partner appoints 1 or more specific officers
  – Officers to be appointed by each partner can also alternate

Advantages of these arrangements include:
• Partners have more meaningful voice in day-to-day management of the venture
• Build a deeper management team

Disadvantages of these arrangements include:
• Complexity (especially if more than two partners)
• May enforce “separateness” rather than facilitate joint venture operation
• May cause officers to align with a partner (and its interests) rather than with interests of all partners and the joint venture
6. Governance Issues – Deadlocks
Governance Issues – Deadlocks

• Partners in a 50/50 venture often worry about how to deal with deadlocks
• Partners in other types of ventures also worry about deadlocks or the venture’s inability to act if partners have veto rights
• Variety of mechanisms can be used to resolve these situations
• What kinds of deadlocks / inability to act due to the exercise of veto rights should trigger a resolution mechanism? Decision should be tailored for each venture
  – Can deadlocks occur on any board issue or only on particular issues?
    • Partners may limit triggers to deadlocks on significant issues, such as approval of the venture’s budget or a change in the venture’s scope
    • List of triggers is likely to be shorter or longer depending on severity of the consequences. For example, if a partner can terminate the venture due to deadlock, the list may be very short
Governance Issues – Deadlock Resolution Mechanisms

Partners often use one or more of the following deadlock resolution mechanisms:

• Bounce the decision upstairs
• Negotiation
• Mediation
  – Consider identifying the mediator in the venture agreement, or a process to select a mediator
• Arbitration
  – Consider identifying the arbitrator in the venture agreement, or a process to select an arbitrator
Governance Issues – Deadlock Resolution Mechanisms

Deadlock resolution mechanisms, continued:

• A third-party decision maker (not an arbitrator) named in the venture documents decides
  – This is an unusual resolution mechanism; usually used for industry expertise
• Sale of the venture company
  – Generally used only for the most significant problems
  – Raises additional issues: e.g., how will sale process be conducted?
    - What price must the partners accept in the sale?
  – Are the partners permitted buyers?
• Withdrawal
• Termination
• Funding effects
Governance Issues – Deadlock Resolution Mechanisms

Deadlock resolution mechanisms, continued:

• Buy/Sell: Either partner may initiate buy/sell process by offering to (a) buy the other partner’s equity or (b) sell its equity to the other partner
  – Generally, the other partner must accept (a) or (b)
  – Alternatively, the other partner can make the same offers to the initiating partner, but at a higher price
  – Ideally, the partners have the same financial resources and condition
Exit Provisions - Make sure there is a way out

- Exit mechanisms include withdrawal, sale of the venture company, buy/sell provisions, put and/or call rights and termination of the venture
- Establish exit rights up front; can’t predict how partners’ bargaining positions will shift over time

Reasons to include exit mechanisms:
- Ultimate resolution if deadlocks are unresolvable / creates incentive to resolve deadlocks
- Allow withdrawals by non-defaulting partners if a partner breaches / deters breaches of the venture agreement
- Alternative for dealing with a change of control of a partner
- Provides more certainty to partner(s) who joined the venture in order to exit the business conducted by the joint venture in stages
- Provides an exit if, after a specified period:
  - Partners no longer believe the venture can fulfill its objectives
  - Partners want to monetize their investment by selling equity
Exit Provisions – One size does not fit all

When designing and negotiating exit provisions, keep in mind:

• The venture’s purpose
  – Was it formed to give partner(s) the ability to exit the business of the venture company in stages? If so, right to initiate a sale process may be an appropriate exit mechanism, but not a call right

• Partners’ investment horizons and liquidity needs

• Partners’ respective financial resources
  – If one partner lacks sufficient resources to buy out the other, call rights or a buy/sell mechanism may not be equitable, or may need to be adjusted (e.g. price payable over time or through seller financing)

• Joint venture’s financial resources
  – Will the venture be able to redeem equity from withdrawing partners?

• Applicable regulatory or contractual limits
  – Legal, accounting and contractual consequences if the identity or ownership percentages of the partners changes
  – Whether pricing of interests should vary depending on circumstances (e.g. FMV versus a discount if partner is withdrawing/has breached)
Exit Provisions – One size does not fit all

Exit provisions should address:

- Consequences of withdrawal under agreements between the withdrawing partner and the venture:
  - Technology licenses or real property leases
  - Commercial contracts such as distribution agreements or service/support agreements
  - Guarantees of venture debt or other obligations
  - Confidential information
    - Obligation to return or destroy confidential information
    - Withdrawing partner’s ability to disclose or use venture’s confidential information
  - Survival of restrictive covenants
    - Non-competition & non-solicitation
  - Withdrawing partner’s right to continue to participate in economics of the venture
8. Shared Asset Issues
Shared Asset Issues

Shared assets exist or are created when:
• A partner retains rights to use assets it contributed to the venture
• A partner licenses or leases assets to the venture
• The venture gives rights to partners to use the venture’s assets
• The venture and partners jointly develop assets
• A venture name or trademark is related to a partner’s name or trademarks

If assets are shared, partners must resolve various issues:
• How is the use of tangible assets allocated among different users?
• Who pays to maintain the assets?
• Can the assets be sublet, subleased or sublicensed?
• Whether the assets can be encumbered by any user
• Who owns / can use improvements to the assets?
• Are there limits on how the assets can be used?
• Who controls decisions about the assets?
Shared Asset Issues

Will assets continue to be shared when a partner that owns or uses shared assets exits the venture?

What happens to shared assets if the venture terminates?

• Will the assets be sold?
• Will assets be given to particular partner(s)?
• If assets are not sold, how are they valued for purposes of distributing the joint venture’s assets?
Shared Asset Issues

Additional issues if intellectual property assets are shared:

• Do the owner and other users have to inform each other of improvements?
• What rights do the owner and other users have to develop, use, license or transfer derivative works created from shared IP?
• Who defends and pursues infringement claims brought by or against third parties?
• Where and how will the shared IP be registered?
• What rights do partners have to use, license or transfer IP developed by the venture that is not derived from shared IP?
Summary and Q&A

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