

Vive la Différence?  
Select Joint Venture Issues in the  
United States and Europe

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## MCLE Certificate Information

- Most participants should anticipate receiving their certificate of attendance in four weeks following the webcast.
- Virginia Bar Association members should anticipate receiving their certificate of attendance in six weeks following the webcast.
- All questions regarding MCLE Information should be directed to Jeanine McKeown (National Training Administrator) at 213–229-7140 or [jmckeown@gibsondunn.com](mailto:jmckeown@gibsondunn.com).

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# Introduction



# Introduction

- **Our goal today is to:**
  - Focus on some of the most common issues in joint venture formation and compare how they are addressed in the U.S., France and Germany, including:
    - Formation issues
    - Contributions of assets and liabilities
    - Employee issues
    - Governance issues
      - In 50/50 ventures
      - In ventures with minority partners
    - Financing issues
    - Tax issues
    - Deadlock resolution
    - Exit provisions
      - Exit rights
      - Exit right triggers

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# Key Issues in Joint Venture Formation



# Key Issues in Joint Venture Formation – Formation Issues

**Partners and their counsel should consider the following formation issues:**

- Identify partners
- Allocate equity among partners
- Select venture form
  - Corporation, LLC or partnership
- Define scope
- Contributions
  - Initial and additional
- Rights to distributions
- Representations and warranties
- Conditions to closing
- Indemnification
- Consolidation

# Key Issues in Joint Venture Formation- Operational Issues

**Partners and their counsel should consider the following governance and operational issues:**

- Composition of managing board
- Partner approval rights
- Fiduciary obligations / waivers
- Appointment of management
- Deadlock resolution
- Transferability of equity
- Employee issues
- Intellectual property issues
- Restrictive covenants
- Exit rights
- Termination
- Disposition of assets on termination

# Key Issues in Joint Venture Formation- Employee Issues

**Partners and their counsel should consider the following employee issues:**

- Who is the employer?
  - The venture, one or more partners or a combination?
- Who makes employment-related decisions?
  - The venture, one or more partners or a combination?
- Cost allocation issues if a partner seconds/leases employees to venture
- Who provides benefits to venture employees?
  - The venture or a partner or a combination?
- Do venture employees receive equity compensation?
  - Do they receive equity in the venture or in a partner?



# Key Issues in Joint Venture Formation- Financing Issues

## Initial Contributions

- Type (cash, assets, services)
- Timing
- Valuation
- Diligence

## Additional Financing

- Parties will likely negotiate annual operating and capital expenditure budget
- Consider whether additional financing should be provided by partners or third parties
  - Penalties for partners failing to provide financing when required
- Consider whether additional financing should be in the form of equity or debt

## Impact of Contributions on Governance

- Governance rights tend to follow capital contributions. If a party contributes most of the cash, they get most of the votes
- Other rights may also be affected by size of investment.
  - E.g., exit rights for the majority partner may be different from the exit rights for minority parties

# Key Issues in Joint Venture Formation- Tax issues

## Partners and their counsel should consider the following tax issues:

- First step: understand the role and functions to be performed by the Joint Venture
- Second step: identify and understand the respective tax constraints of each partner
- Third step: identify the appropriate place to set-up the Joint Venture and legal form
- Fourth step: identify assets to be contributed and financing of the Joint Venture
- Choice of the legal form of the venture and key differences – general principles:

<b>Legal form</b>	<b>Legal personality</b>	<b>Tax transparency</b>
<b>Contractual joint venture</b>	No	Yes (de facto)
<b>Joint venture partnership</b>	Yes (most often)	Flexible choice
<b>Joint venture company</b>	Yes	No (but elective in the US)

# Key Issues in Joint Venture Formation- Tax issues

**Partners and their counsel should consider the following tax issues:**

- Choice of the legal form of the venture and impact regarding the transfer of assets:

Legal form	Transfer of assets	Tax aspects driving the choice of assets transferred
Contractual joint venture	No	N/A
Joint venture partnership	Possible Transfer by way of contribution, sale, lease or license	Capital gains tax Transfer taxes VAT/sales tax
Joint venture company		Key facts driving the transfer of the assets: functions performed by the JV, duration of JV (short term/long term), willingness to contribute IP to joint venture

# Key Issues in Joint Venture Formation- Tax issues

**Partners and their counsel should consider the following tax issues:**

- Choice of the legal form of the venture and impact regarding the operation of the business:

<b>Legal form</b>	<b>Business income</b>	<b>NOLs</b>	<b>Profit repatriation</b>
<b>Contractual joint venture</b>	Remains at each partners' level	N/A	N/A
<b>Joint venture partnership</b>	Partners taxed on their share of JV profits	NOLs allocated to Partners	Usually no WHT issues (branch tax?) Local tax returns to be filed by the partners
<b>Joint venture company</b>	JV Co fully taxed at local CIT rate	NOLs belong to JV Co (subject to tax grouping rules)	Need to declare dividends (potential WHT tax issues)

# Key Issues in Joint Venture Formation- Other Tax Issues

## Funding

- Funding via debt or equity accomplishes different objectives
- Need to understand limitations placed on interest deductions and thin cap requirements as well as withholding tax issues

## Tax treaty benefits

- JV partnership : usually no entitlement but partners may be entitled to treaty benefits
- JV company : usually entitled to tax treaties
- Prefer the choice of a jurisdiction that has entered into a significant number of tax treaties

## Transfer pricing issues

- Often not clear whether the JV is a related party vis-à-vis the partners or one of them
- Need to assess the functions performed by the JV (e.g. limited risk distributor ?)
- Determine an appropriate transfer pricing methodology to ensure arm's length transfer prices between the JV and the partners

## Miscellaneous

- Agree in the JV agreement on clear allocation of tax responsibilities between the partners and governance rules regarding the JV tax matters and tax audits
- Anticipate development of the JV's business in other jurisdictions and define an extension plan
- Anticipate duration of the JV and tax consequences of the termination of the JV, including an exit plan

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# Formation Challenges



# Getting Started – Why Is It So Hard?

Negotiating and drafting joint ventures is very challenging

## Challenges include:

- Often more difficult than negotiating and drafting an acquisition agreement
- Joint ventures contemplate ongoing business relationships, not one-time transaction
  - Need durable and flexible relationship to allow for change as business plans, market conditions and other factors evolve
- No standard “off-the-shelf” deal
- No “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., 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:

- Help impose order on complex discussion
- Focus business people on critical choices
- Confirm agreement 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 venture may promote success
  - Partners feel committed to 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 plan* for joint venture with more detail than term sheet or LOI
  - *Roadmap for formation* of venture including timelines for negotiating deal agreements, obtaining required consents, contributing assets and closing
  - *List conditions* to closing and describe closing mechanics
  - *Keep certain provisions separate* from governance documents, e.g., representations & warranties and indemnification
- Avoid rush to completion that can result in leaving difficult issues unanswered

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# Typical Governance Structures



# Typical Governance Structures

## 50/50 Joint Venture

- Management responsible for day-to-day operations
- Governing board oversees management
  - Each partner appoints same number of members to board
  - Members are removed and replaced by partner that appointed them
- Specified actions require board approval, including minimum number of board members appointed by each partner
- Partners have separate voting rights
  - *E.g.*, new budgets or fundamental actions such as changes in venture's scope must be approved by both partners
- One or more deadlock resolution mechanisms, such as buy-sell mechanism
- Unresolved disagreement between partners may lead to termination of venture

# Typical Governance Structures

## 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 majority of board
  - Members are removed and replaced by 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 approval likely to be shorter than in 50/50 deal
- One or more deadlock resolution mechanisms

# Typical Governance Structures

**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 number of matters partners must approve
  - Avoids delay
  - Fewer opportunities for partners with veto power to extract concessions
- Consider impact of fiduciary obligations on board decision-making
- Consider if there is a role for:
  - Independent directors
  - Board committees
  - Advisory boards

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# Governance Issues – Governing Boards & Management



# Overview

- *Type of governing body of JV will depend in part on entity type of JV*
  - Corporation, limited liability company or partnership
- *Corporation: state corporate law will largely provide framework for operations of the board of directors*
- *LLC/Partnership: state law will generally offer greater flexibility to select governing structure*
  - Direct management by JV parties
  - Single manager or managing member
  - Board of Managers
- *Greater flexibility also means parties should carefully consider all relevant issues and reflect their understanding in JV agreement*
  - State law will fill in fewer gaps or may provide a default answer different from one or both party's intent

# Governing Board: Primary Issues

**Issues regarding operation of Board of Managers largely mirror those of corporate Board of Directors**

- Board size and composition
  - Independent managers? Special qualifications? Chairman?
- Number of board members each JV party will have the right to appoint
  - Generally follow ownership, with even representation for 50/50 JV and proportionate representation for majority/minority JV
- Adjustments to or loss of appointment rights based on dilution or increases in ownership
- Board voting
  - **Voting thresholds**: Majority voting is the norm, with supermajority or unanimous votes required on fundamental items or for minority protection
  - **In a 50/50 deal**, a majority vote requirement is the equivalent of a supermajority or unanimous vote requirement
  - **Developing list of actions** requiring supermajority approval
  - Resignation, removal and filling of vacancies
- Matters reserved for action by JV partners as equity holders
- Indemnification, compensation, fees and expenses



## Governing Board: Primary Issues (cont'd)

- Don't forget the details:
  - Quorum requirements
  - Notice requirements
  - Regular & special meetings
  - Telephonic meetings
  - Actions by written consent
  - Who can call meetings? Partners? Board? Officer?
  - What actions may be brought at meetings?
  - Adjourned meetings
  - Taking care of details is easier if venture is a corporation, since state corporation laws fill in many blanks

Details are sometimes thought not to matter, until there is a dispute

# Member-Managed

- Issues to consider include:
  - Member-managed LLC will result in members having greater day-to-day involvement in the business
  - In most states, member-managed LLC is the default
  - JV can also designate one member (or more) to serve as “Manager” of the LLC
    - Or can also determine to have a manager-managed LLC where the manager is not an equity holder
  - If there is a managing member (or independent manager), issues of fiduciary duties, exculpation and indemnification
    - In Delaware, managing member in its capacity as Manager of LLC will have default fiduciary duties under state law
  - Corporate opportunities and non-competition
    - In managing the JV, members may more likely become privy to opportunities that could benefit them outside scope of JV
  - If management is vested in majority member, particularly important to minority member to provide for information rights and regular/special meetings of members
  - Member approval thresholds and supermajority requirements
    - Need clear decision-making protocol in absence of governing body
  - Will officers be elected and what will be their scope of authority?
  - Indemnification, compensation, fees and expenses

# Governance Issues – Board Fiduciary Duties

**Board members' fiduciary obligations will impact board decision-making**

- Generally, board members have fiduciary obligations to all partners, not just appointing partner
- A partner may expect its board representatives to act exclusively in the partner's interest. Unless fiduciary duties are waived, board must act in best interest of *all* partners
- Certain issues may be avoided by giving partners direct decision-making authority
- Partners should consider whether to waive all fiduciary obligations of board
  - Board members must still act in good faith
  - Limited waivers of certain fiduciary duties may be an option

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## Governance Issues – Deadlocks



# Governance Issues – Deadlocks

## How to Resolve Deadlocks?

- Partners in 50/50 venture often worry about how to deal with deadlocks
- Partners in other types of ventures also worry about deadlocks or venture's inability to act if partners have veto rights
- Variety of mechanisms can be used to resolve deadlocks
- What kinds of deadlocks / inability to act due to exercise of veto should trigger resolution mechanism?
  - Any board issue or only particular issues?
    - Partners may limit triggers to deadlocks on significant issues, such as approval of venture's budget or change in venture's scope
    - List of triggers likely to be shorter or longer depending on severity of consequences; for example, if a partner can terminate venture due to deadlock, list may be very short
  - Tailor deadlock resolution approach for each venture

# 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 mediator in venture agreement, or process to select mediator
  - Arbitration
    - Consider identifying arbitrator in venture agreement, or process to select arbitrator
  - A third-party decision maker (not an arbitrator) named in venture documents decides
    - Unusual resolution mechanism
  - Sale of venture company
    - Generally used only for the most significant problems
    - Raises additional issues: *e.g.*, how will sale process be conducted? What price must partners accept in sale?

# Governance Issues – Deadlock Resolution Mechanisms

- **Additional deadlock resolution mechanisms:**
  - Withdrawal
  - Termination
  - 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 same offers to initiating partner, but at higher price
    - Ideally, the partners have same financial resources and condition
  - A McKinsey & Co. study found that over 75% of 2 party ventures that terminated ended with an acquisition by one of the partners

# Governance Issues – Board Deadlocks

Partners may limit availability of resolution mechanism to different kinds of deadlocks or require specific criteria to be met

- Negotiation and mediation have least severe consequences (in and of themselves) so may be applied more broadly
- Arbitration may not make sense for resolving deadlocks on business matters
  - May be better suited for resolving claims of alleged contract breaches or contract interpretation issues
- Use of mechanisms like selling or terminating venture may be limited so they only apply if venture achieves – or fails to achieve – certain results

Some partners prefer not to provide any deadlock resolution mechanisms

- Inability of venture to act absent agreement of board or partners incentivizes agreement
- Risk: in Delaware, 50/50 joint venture party can petition court for dissolution if parties did not specify deadlock resolution mechanism



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## Other Governance Issues



# Minority Protections

- **Supermajority Board Approval:** Certain board actions generally require an affirmative vote of at least one designee of the minority partners or approval of more than 50% of equity holders or board members, such as:
  - Guarantees of debt;
  - Additional capital contributions;
  - Issuance of additional equity interests or admission of new members;
  - Approval of related party transactions with majority member; and
  - Material changes to the business or location of the JV.
- **Board Observer Rights:** Minority member may be given observer rights in lieu of direct representation.
- **Minority Consent Rights:** Certain fundamental transactions require approval by a majority in interest of the minority partners, such as: (i) change of control, (ii) dissolution or (iii) amendment to governing documents.
- **Other Rights:** May also have direct right of veto or approval attaching to only certain equity class.
- **No Board:** If there is no board, minority protections could be enhanced by requiring meetings of members (with specified quorum and notice requirements) and provisions regarding special meetings

**In the case of majority/minority JVs, the minority partner will seek structural protections to be incorporated in the JV governance model**

# Corporate Opportunities Doctrine

- Basis: Managers of a venture will have a duty of loyalty to the entity unless that duty can under state law be (and is) expressly waived.
- Corporate opportunities doctrine: 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
- Corporate 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.
- Few bright-line legal 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.
- Persons otherwise bound by corporate opportunity obligations may face conflicting loyalties.
  - Manager appointed by partner may have fiduciary duties to the partner entity as well as to the JV entity.
  - Opportunity law does not provide clear solutions to these conflicting duty problems.
- 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.

# Corporate Opportunities: Best Practices

- *Define the scope and applicability of the opportunities provision carefully*
  - ***What is the scope of venture's business for purposes of the opportunity doctrine? What opportunities are the partners interest in pursuing through the venture?***
  - *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?*
- *If corporate opportunity doctrine is not completely waived, create a clear process and timeline for the venture to consider the opportunity*
  - **e.g., Disclosure and consent**
    - What if an entity won't consent?
    - What if disclosure by itself could be viewed as a breach of fiduciary duty?
- *Establish a clear procedure for the venture to follow when considering the opportunity.*
- *If the venture pursues the opportunity, create a clear process for the venture to negotiate the opportunity with any relevant third party.*
- *Address how the ability to pursue an opportunity fits with the non-compete provision, if any.*

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# Exit Provisions



# Exit Provisions – Make Sure There Is a Way Out

**Exit provisions can be a difficult topic to address when parties are only just structuring the venture**

## **Reasons to include exit mechanisms:**

- All ventures come to an end
- Ultimate resolution if deadlocks are unresolvable / creates incentive to resolve deadlocks
- Allow withdrawals by non-defaulting partners if a partner breaches / deters breaches of venture agreement
- Alternative for dealing with change of control of a partner
- Provides more certainty to partner(s) who joined venture in order to exit business conducted by joint venture in stages
- Provide an exit if, after a specified period:
  - Partners no longer believe venture can fulfill its objectives
  - Partners want to monetize their investment by selling equity

**Establish exit rights early; can't predict how partners' bargaining positions will shift over time**

# Transferring the Joint Venture Interest

## Transfer Restrictions

- Often include lock-up (i.e., period of 3-5 years when neither partner may transfer its interest)
  - Intended to give the venture time to succeed before either partner may seek to exit
- Permitted transfers
- Preemptive rights/anti-dilution protections
- Right of first refusal/right of first offer
- Tag-along/co-sale rights
  - Applicable to all transfers v. transfers over a certain percentage
- Drag-along rights
  - Applicable only in a change of control v. any sale transaction

# Exit Strategies

## Exit Triggers

- Venture success
- Venture failure
- Passage of time
- Disputes between partners; deadlock
- Partner breaches venture agreement
- Partner changes business strategy or encounters business problem
- Change in control of partner

## Exit Mechanics

- Sale of entire venture to third party
- Transfer of venture interest to third party
- Transfer of venture interest to partner
- Buy-sell devices
- Termination and liquidation of joint venture
- Right of forced sale if other partner breaches, encounters difficulty; or if venture fails; or if venture succeeds; or if partners deadlock.
- Depending on trigger, different mechanics may work better



# Buying Out the Other Partner

## Buyout Provisions

- Put and call rights, applicable upon the occurrence of, among others:
  - Breach;
  - Means of deadlock resolution; and/or
  - Exit options
  - Need to consider triggers to exercise and price determination
- Buy/sell arrangements use various valuation methods including:
  - Russian Roulette;
  - Texas Shoot-Out;
  - Dutch Auction;
  - Modified Russian Roulette; and/or
  - Third-party/arbitration

# Exit Provisions – One Size Does Not Fit All

- **When designing and negotiating exit provisions, keep in mind:**

- Venture's purpose
  - Formed to give partner(s) ability to exit business of venture company in stages? If so, right to initiate a sale process may be 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 buy/sell may not be equitable
- Joint venture's financial resources
  - Will venture be able to redeem equity from withdrawing partners?
- Applicable regulatory or contractual limits
  - Legal, accounting and contractual consequences if identity or ownership percentages of partners changes

# Exit Provisions – One Size Does Not Fit All

- **Exit provisions should address:**
  - Consequences of withdrawal under agreements between withdrawing partner and 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 venture

## Questions? Please contact any of the presenters.

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