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Negotiating Joint-Venture Management Provisions: A Primer

Law360, New York (January 14, 2014, 3:11 PM ET) -- The management provisions are among the most important and heavily negotiated terms of the joint venture agreement. Regardless of the form of the joint venture, the co-venturers must establish a management vehicle to run the day-to-day activities of the business. The management vehicle may take a variety of forms:

- *Corporation*. A corporate joint venture will have a board of directors whose operations will be governed by the relevant state statute. Counsel should consult the relevant statute, which may have certain requirements for how board members are elected and/or replaced. Management provisions regarding board composition and the election and removal of directors are typically found in both the charter and the bylaws or shareholders' agreement, so that they cannot be changed without a stockholder vote. Provisions regarding procedural matters, like designating directors, are usually found in the stockholders' agreement.

- *Limited Partnership*. A limited partnership is typically governed by an entity formed to act as the general partner, with co-venturers appointing representatives to the general partner's managing board. Note, however, that under some state statutes, a limited partner that gets involved in the partnership's management may lose its limited liability status.

- *LLC*. A limited liability company can be supervised by either a manager or a board of managers comprised of the co-venturers' representatives, under most state limited liability company statutes. In some states, LLCs may be managed directly by their members or by officers appointed for the purpose. There is generally significant flexibility in fashioning the management provisions of an LLC, which is one of the reasons that the LLC is fast becoming the preferred joint venture structure.

What follows is a description of the key aspects of the management provisions of a joint venture agreement.

Composition of the Managing Board

The parties must first agree on the composition of the managing body of the joint venture. In forming a committee or board of managers or directors, the co-venturers must consider the following factors:

- *Size of the Board*. The parties must establish the size of the board, which will usually depend on how many venturers there are, as board representation is typically proportionate to each member's ownership interest in the joint venture. In some cases, board representation may be determined by some other set formula.

- *Selection of Representatives*. There are several ways to approach the selection of representatives to serve on the managing committee or board. The parties may choose to grant one another freedom and flexibility in choosing their respective representatives. In other ventures, the agreement may stipulate that representatives appointed to the managing body must have certain credentials or a certain level of seniority. In some cases, the joint venture parties work together to identify certain individuals from each member of the joint venture who will be granted decision-making authority, and they may also seek some veto rights over successors, as discussed below.

- *Veto Rights*. Venturers do not usually have the right to consent to another partner's nominations for the managing committee or board. However, if they do have veto rights, the agreement usually states that such rights cannot be exercised unless a certain threshold percentage of the co-venturers object to the nominee, or that such consent cannot be "unreasonably" withheld. In lieu of (or in addition to) veto rights, co-venturers may specify criteria that nominees must satisfy in order to be appointed to the managing board.

- *Replacement of Board Members*. Oftentimes, the joint venture party that appoints a director or manager has the exclusive right to remove and/or replace that director upon written notice to the other joint venturers. However, joint venture agreements often provide that a party will lose these rights if it defaults on its obligations under the agreement and/or its equity interest in the venture falls below a certain threshold. Once the default is cured or the interest is increased, the venture will usually regain the right to remove and/or replace its representatives on the managing board.

- *Minority Partner Rights*. Minority joint venture partners may not have any right to representation on the board, but may have observer rights allowing them to designate an individual to attend and observe the meetings without voting.

- *Defaults*. As mentioned above, joint venture members may lose the right to remove and replace their representatives if they default on their obligations under the joint venture agreement. They may also lose their representation on the board entirely in case of a default that remains uncured.

Independent Directors

If the joint venture is particularly large or has multiple partners, or may go public in the future, the parties may want to consider placing independent directors on the board in addition to the directors appointed by each of the members. Using independent directors may help:

- resolve conflicts among the parties, especially if the parties have equal voting control and there is a risk of deadlock over certain issues;

- facilitate decision-making and compliance with fiduciary duties under applicable law;
- give voice to the interests of minority partners who are not entitled to board representation;
- provide industry, management, technical or some other expertise that the venture partners do not have but need;
- ease the joint venture's transition from a private company to a public company if the joint venture decides to undertake an initial public offering, as applicable rules and regulations typically require the inclusion of independent directors on public company boards .

Of course, independent directors may not be necessary or appropriate if:

- the joint venture will remain a private company;
- the members are comfortable with control being consistent with their relative percentage ownership interests in the joint venture; and/or
- the venturers wish to forego any claims against each other regarding potential violations of fiduciary duties.

If the co-venturers decide to use independent directors, before selecting nominees, the parties should review:

- the rules and regulations of the stock exchange(s) on which the joint venture may list for the requirements for a director to be considered independent; and
- applicable state law for any other independence requirements.

If independent directors will be used, the parties should include a mechanism for selecting them in the joint venture agreement:

- *Identification:* Typically, the nominees are identified by one or more joint venture parties that must confirm that each nominee meets all applicable requirements for independence.
- *Confirmation:* The nominees are then presented to the board or governing body of the joint venture and will be confirmed by a designated vote of the remaining joint venturers that did not participate in their selection and identification.

Use of Special Committees

Joint ventures with large management boards may want to establish special committees to help streamline the decision-making process where possible. Special committees have a number of potential benefits:

- *Expertise*. Special committees comprised of fewer individuals, some of which have specialized knowledge, are often better equipped to handle a variety of issues, including audits, compensation and technical matters.

- *Resolution of Conflicts of Interest*. Venturers may also use special committees to help resolve conflicts of interest between the joint venture and its partners or management.

- *Compliance with Fiduciary Duties*. Special committees may also be formed to ensure that the managing board complies with its fiduciary obligations. For example, the venturers may want a special committee formed to consider and approve an interested party transaction between the joint venture and one or more of its members.

If the managing board will potentially use special committees, it should include a board committee provision in the joint venture agreement, which will typically include the following:

- *Formation*. Typically, the joint managing board may form a committee by a resolution passed by a majority of the board.

- *Members*. To preserve flexibility, the provision will often stipulate that any board committee will consist of one or more directors or managers of the joint venture, and that the board will designate the members of any special committee.

- *Alternates:* If a member of the committee is disqualified or otherwise absent, the members present at any committee meeting may vote unanimously to choose another member of the board to serve on the committee.

As with independent directors, if special committees will be formed, before selecting committee members, the co-venturers should review:

- the rules and regulations of the stock exchange(s) on which the joint venture may list for the requirements for a director that will sit on the committee to be considered independent; and

- applicable state law for any other independence requirements.

When selecting nominees for a special committee, it is also important to consider the purpose for which the committee was formed in order to ensure that the proper persons are chosen.

For instance, if a special committee is formed to ensure that certain decisions are made on an independent basis as required by the directors' fiduciary duties, then state laws regarding director independence will govern selection of the committee's members as opposed to requirements under applicable stock exchange rules. State law may apply a tougher standard than those under applicable stock exchange rules.

Appointing Officers and Executives

As mentioned previously, the management board may choose to appoint executives to run the day-to-day business of the joint venture. Officers will usually include a president, chief executive officer or general manager who will manage operations, and may also include a chief financial officer and secretary, among others. When drafting provisions that provide for the selection of these officers or executives, the joint venture partners and their counsel should consider the following:

- *Selection of Officers*. The parties should consider how these executives will be chosen. Will a majority vote by the management board be enough to appoint a nominee? Do the CEO and other officers need to be chosen unanimously by the joint venture parties? If one party has experience in the industry or business in which the joint venture operates and could easily supply employees with the right experience, perhaps that partner should choose the officers of the joint venture. Much will depend on the size and nature of the joint venture and the number of parties involved.

- *Veto Rights*. As with management board selections, joint venture partners may be granted the right to veto officer selections under certain circumstances. If they do have such veto rights, often the agreement will stipulate that they cannot "unreasonably" withhold their consent.

- *Replacement of Officers*. If the managing board chooses an officer, his or her replacement will often require supermajority approval, or the board will be unable to terminate the employee without "cause" under the terms of the agreement. In this case, "cause" should be particularly well-defined in the joint venture agreement, and usually includes things such as: (1) criminal convictions, (2) willful and continued failure to substantially perform duties (potentially including failure to perform related to an illness if such illness and failure to perform continue beyond a specified period of time); (3) fraud, embezzlement, theft or other material violations of law; (4) material violations of company policies (including with respect to confidentiality) and/or (5) damage to company assets. If one joint venture partner chooses a particular officer, then that partner usually has the exclusive right to remove and/or replace that officer. If a joint venture partner has reasonable concerns that another venturer's selection may not be appropriate, then such partner may have some ability to remove that officer for a limited period of time after selection (usually one to two years). This right to remove another member's officer is most likely to be awarded to those joint venture parties holding a significant ownership stake in the venture.

- *Limits on the Officers' Authority*. Even if the officers will be running the day-to-day affairs of the joint venture, there are still some major decisions that are typically reserved for the managing board (or all of the joint venture partners, depending on the management structure chosen), which are discussed in more detail under "Reserving Key Decisions for the Management Committee or Board" below.

Managing Day-to-Day Business of the Joint Venture

Once the governing body of the joint venture has been formed, the parties must decide who will handle the day-to-day affairs of the joint venture. They can choose one or more representatives from the managing board to handle daily operations, or, as discussed above, they can appoint separate officers and executive employees to manage the venture's affairs.

A very simple management structure might provide that one joint venture party acts as the managing member, while officers and/or executive employees handle day-to-day decision-making. If all joint venture parties have committed significant cash, assets and other resources to the joint venture, and if the venture requires significant management expertise from each party, then the day-to-day issues may be handled by the management committee, by all of the joint venturers or by a majority of the co-venturers.

Regardless of how ordinary-course business operations are managed, management will usually be required to act consistent with the business plan or budget crafted by all of the joint venturers on an annual or regular basis.

The joint venture agreement should clearly set out which matters or decisions are within the purview of the day-to-day managers of the business. These items will vary depending upon the venture, but they are typically more ministerial in nature and often include the following:

- actions necessary or advisable to comply with existing contracts;
- actions necessary or advisable to carry out items set forth in the relevant budget or business plan, including the payment of fees and expenses and entering into necessary contracts;
- actions necessary or advisable to comply with existing laws and ordinances, including communications and dealings with government officials, that are consistent with the relevant business plan or budget; and
- maintaining the books and records of the joint venture.

Reserving Key Decisions for the Management Board or All Joint Venture Members

As mentioned previously, regardless of who is managing the day-to-day affairs of the joint venture, there is usually a subset of key matters that will be reserved for the managing board (if executive officers are managing the daily affairs of the joint venture) or all of the joint venture partners to decide.

The joint venture agreement usually sets forth an extensive list of items that constitute key or major decisions that are reserved for the board. The list varies depending on the form and nature of the venture, but it usually includes the approval of, and amendments to, the budget and business plan, and other matters involving a certain dollar magnitude or materiality threshold that are not otherwise covered in that budget and plan.

Major decisions may also be further divided into categories, some of which require only a majority vote and others that require supermajority approval.

Key decisions that require the input of the management board or all or a majority of the co-venturers typically include:

- approval of the annual business plan and budget and any amendments thereto;

- amendments to the governing documents of the joint venture;
- admission of additional joint venture members;
- a change of the name of the joint venture entity;
- any material change in the scope of the business of the joint venture;
- establishment of and/or change in the management board or committee;
- hiring and firing of the managing officers or executives;
- compensation of the management team;
- creation of subsidiaries;
- the sale, license, exchange or other disposal of joint venture property;
- entering into material contracts valued above a certain dollar threshold;
- lending funds, incurring indebtedness, or granting security or guarantees in excess of a specified amount;
- hiring or firing certain identified employees of the joint venture or employees at or above certain management levels of the joint venture;
- initiation or settlement of claims;
- the purchase of property or assets;
- consummating mergers, acquisitions or other business combinations involving the joint venture (excluding ordinary course acquisitions of assets);
- the selection of accounting or law firms or other key outside advisors;
- bankruptcy filings; and
- entering into transactions with a joint venture party and any of its affiliates.

It should be noted that the amendment provisions of the joint venture contract also impact the management of the joint venture because some amendments may require unanimity, others a supermajority and others a simple majority.

Conflicts of Interest and Codes of Conduct

A critical issue facing co-venturers is the balancing of the interests of the joint venture with those of their individual businesses, especially when the joint venture enters into arrangements with one or more of its members to supply certain goods and services. A joint venture may:

- permit the managing member or board to resolve these conflicts on a case-by-case basis as they arise; or

- develop codes of conduct and/or policies governing business dealings between the joint venture and its members and/or affiliates that must be applied uniformly in all cases.

Regardless of which approach a joint venture takes, the joint venture agreement will usually require the following:

- *Full Disclosure*. The agreement will require full disclosure of the terms of all interested party transactions to the joint venturers or managing board.

- *Approval*. The terms of such transactions must be approved by a specified vote of the joint venture members or managing body who are independent and uninvolved in the transaction.

It may be prudent to develop codes of conduct or policies to deal with conflicts because they: (1) shift burdens of proof and (2) may also provide some initial protection against alleged violations of certain laws, such as the Foreign Corrupt Practices Act (78 USCS §78a) or the Investment Advisers Act of 1940, among others.

If a joint venture party has a reasonable concern that the provisions of a particular code or policy may materially or disproportionately affect its interest in the joint venture, it may seek to set forth the principal terms or provisions of such code or policy in the joint venture agreement or an exhibit to the agreement.

Otherwise, such codes and policies will be developed in the ordinary course of business and, if material, approved by a majority vote of the board or other governing body.

Other Procedural Matters

The management provisions of a joint venture agreement should also clearly lay out the procedural details of how the board or other managing body will operate, including, but not limited to, the following:

- *Deadlock*. If there is an even number of representatives on the managing board, the co-venturers will need to decide how to deal with the possibility of deadlock. One solution is granting the chair of the board a casting vote. Another solution would be to appoint a certain number of independent directors to the board, as discussed above, or to trigger exit rights.

- *Board Meetings*. The joint venture agreement should set forth how frequently the board will meet, who can call special meetings and under what circumstances. A joint venture agreement may call for a specific number of meetings to be held each year at a specific place. An agreement may also offer more flexibility by providing that regular board meetings will be held at least a certain number of times each year at a time and place of the board's choosing. Typically, special meetings may be called by the chair of the board or committee any time by giving the required notice.

- *Notice Requirements*. The agreement should set forth any notice requirements for special meetings. Generally, joint venture agreements require written notice at least five to 10 days before the special meeting. Notice requirements can usually be waived in writing.

- *Voting and Quorum Requirements*. The terms of the agreement should detail voting procedures and the quorum required to conduct business at a board or committee meeting. The venturers must decide if all decisions by the board can be decided upon a simple majority vote, or if some matters need to be decided by a supermajority.

- *Action by Written Consent*. The co-venturers must also decide whether the board should have the power to act via telephonic meetings or by written consent without holding a board meeting. Typically, joint venture agreements allow action by written consent to allow the board flexibility to take action in the face of emergencies or unanticipated events, and generally to make conducting business easier as a practical matter. Look to the appropriate state statute to see if action by written consent must be unanimous, and be sure to indicate this in the provision.

- *Meeting Minutes*. The agreement should set forth procedures for the preparation, delivery and approval of minutes of meetings of the members.

- *Compensation*. The co-venturers must decide whether or not to compensate managers for overseeing the joint venture, and whether that compensation will consist of equity awards in the joint venture. By giving the directors or managers equity or opportunities to earn equity, the managers' interests will be more aligned with those of the joint venture. However, if the joint venture is intended to remain operative or be unwound without a sale, a bonus plan would be a better means of reaching this objective.

- *Removal and Replacement of Managers*. As discussed above under "Composition of the Managing Board," the joint venture agreement will also set forth procedures for the removal and replacement of members of the management board. Often, a joint venture agreement will provide the party that appointed a member of the board the exclusive right to remove and replace such member or director, with notice to the other joint venturers. A co-venturer who defaults on its obligations under the joint venture agreement or whose interest in the venture falls below a certain threshold may lose its right to appoint members to the managing board.

Note that the joint venture agreement will need to set forth many of the same procedures for meetings of the members of the joint venture, including when and how often they will meet, notice requirements for such meetings, quorum requirements, and other similar provisions as described above.

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