

# Planning for a Successful Joint Venture

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- Co-Chair, Private Equity Practice Group
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  - mergers and acquisitions and private equity transactions
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  - securities regulation and corporate governance matters, including periodic reporting and disclosure matters, Section 16, Rule 144, insider trading and Rule 10b5-1(c) plans
- Named by Variety as one of “Hollywood’s New Leaders” and recognized by Super Lawyers as a Rising Star for Business/Corporate in 2013 and 2014. Author of numerous publications regarding corporate governance, fiduciary duties and securities regulations.

# Table of Contents

	Slide
1. Introduction	5
2. Getting Started	7
3. Defining the Scope of the Joint Venture	11
4. Typical Governance Structures	13
5. Governance Issues – Governing Boards & Management	17
6. Governance Issues – Deadlocks	23
7. Exit Provisions	28
8. Shared Asset Issues	32



# 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.

- 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.

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

- 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



# 7. Exit Provisions

# 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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