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§ 284:64. Business Counselor's Guide to the "Top Dozen" Issues for Client Discussions on Joint Ventures

BUSINESS COUNSELOR'S GUIDE TO THE "TOP DOZEN" ISSUES FOR CLIENT DISCUSSIONS ON JOINT VENTURES

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The following Business Counselor's Guide discusses the issues that should be covered in a candid conversation between an attorney and a client considering a joint venture arrangement. Attorneys often bring substantial experience to structuring, negotiating and documenting joint ventures and can be a valuable resource and sounding board to senior managers as they make the difficult decisions required in order to create a sustainable and successful joint venture.

Throughout business cycles, good and bad, the "joint venture" has remained a staple of the strategic toolbox for companies of all sizes. While the technical legal definition of a joint venture is an association of two or more individuals or companies to engage in a specific business enterprise for profit without actual partnership or incorporation, as a practical matter the joint ventures of today involve the formation, organization, and operation of a separate legal entity (i.e., a corporation, partnership, or limited liability company) that will use cash and other assets contributed by the joint venture participants to pursue business and financial objectives of mutual interest to those participants.

While, as discussed in more detail below, it is the job of the parties to a joint venture to visualize the desired end result and establish a clear and direct plan to achieve it the lawyers representing the parties are the trusted and expert architects of the various pieces of the structure of the joint venture. Assisting clients in the creation and management of a joint venture is one of the challenging, yet fascinating, jobs for a business counselor and calls for a wide range of legal and business skills given that the documents must anticipate the evolution of the joint venture business and the priorities of the parties over an extended period of time.

When approached properly a joint venture will require an extensive amount of planning and it generally several months to negotiate the terms and draft and approve the necessary documents. This is often frustrating to the principals of the parties who often believe that everything is "done" as soon as they initial a two-page term sheet. Nonetheless, the attorney needs to enforce a discipline of the process and ensure that each of the parties has considered the difficult issues that generally spell the difference between success and failure for joint ventures. Attorneys are fond of using extensive checklists that include dozens of questions. While they can and should use whatever tools they need to be sure that everything has been considered, the conversation with the client will normally be more limited, although unforeseen issues and problems can obviously be

raised and resolved as the negotiations and drafting move forward. The sections that follow attempt to boil things down to a "Top Dozen" list of the issues that attorneys for each of the parties interested in a prospective joint venture need to discuss with their clients. Certainly a list of 12 issues will not capture all the details that must be considered in documenting a joint venture; however, the exercise will almost certainly focus the principals on the areas that are key influences on the success of the collaboration.

1. What business objectives is the client attempting to achieve?

Even before attention turns to the details of the joint venture and strengths, weaknesses, and likely negotiating strategies of the other party, the attorney needs to try and understand just what his or her client is attempting to achieve from a business perspective. Certainly a joint venture can be a good way to reduce actual or potential competition from the other party, particularly when there is a concern that the other party has access to resources that would enable it to achieve a business objective more quickly and efficiently than your client and thus foreclose potential opportunities for your client. In most cases, however, the client is interested in adding something new to its existing strengths or remediating a weakness that might be holding it back. Examples include access to, or efficient development of, new technologies and/or finished products; building out cost-effective manufacturing and production capabilities; launching or expanding sales in new markets; or simply exposing managers and employees to new ideas and ways of thinking. Understanding the business objectives of the client allows the attorney to suggest alternative strategies and, if the joint venture remains the preferred route, make sure that the pieces of the joint venture documentation are tightly focused on pursuing and achieving those objectives. By the way, when describing the scope of the joint venture in the documentation both parties need to seek clarity and ensure that their objectives have been stated and incorporated.

2. Why this partner and what does the client think that the partner wants to achieve?

In most cases the client will engage the attorney in a conversation regarding a proposed joint venture after a partner has been selected or at least identified as a serious candidate. In the same way as the attorney needs to understand the objectives of his or her client the attorney must also have some idea of why this particular partner was chosen and the client's "best guess" as to why the partner is interested in pursuing the joint venture. In this part of the conversation the attorney should seek to find out about any special competencies and other resources that the partner may be willing to contribute to the joint venture. With this information the attorney is in a better position to assist his or her client obtain the "benefit of the bargain" in negotiating the terms of the joint venture by ensuring that the competencies and resources are made available to the joint venture. By the way, the attorney should remind the client that legal due diligence leading up to the signing of the joint venture documents can be used as a tool to verify the purported strengths of the partner, such as the breadth and enforceability of any intellectual property rights that the client was planning on asking the partner to license to the joint venture. As for what the partner wants to achieve from the joint venture: the client can never really know for sure since the partner may be unwilling to disclose its true intentions or, in some cases, may not even have a concrete idea of its own. Nonetheless, the client and its attorney should go into the negotiations with some sense of the other party's goals in order to anticipate the issues that may arise in putting the joint venture together and in operating the joint venture after it is launched. For example, the client may be aware that the partner is seeking to enhance its knowledge base regarding the client's manufacturing processes. This may be fine with the client, to a point, and the documentation will likely include licenses for the applicable technology; however, the client should be advised of the need to impose restrictions on the partner's use of the technology lest the client inadvertently create a future competitor.

3. Assuming that a joint venture with the identified partner will achieve the desired business objectives just what is the vision of the client as to how the joint venture would look and operate in five years?

A joint venture is like any new business and, as such, the parties should always develop a mutually-agreed strategic plan for the joint venture before either side invests a significant amount of time and resources or irrevocably commits valuable assets to the project. The attorney generally does not get heavily involved in the strategic planning process; however, he or she should certainly ask the client to describe the "best case scenario" for how the joint venture should be looking and operating

as of a specific point in time after the project has actually been launched. I used five years down the road in the question I posed above but the actual measuring point will vary depending on the circumstances. The point for the attorney is to delve into the mind of the client and see what they are looking for in terms of pace of technology or product development, contributions from the partner, operational and management processes of the joint venture and, of course, "results" in the form of revenues, market share, return on investment etc. The answers to these questions can and should be incorporated into the joint venture documentation in the form of milestones for assessing the progress of collaboration and the attorney should also make sure that the formal legal commitments of the other party in the documentation match the expectations of the client. For example, if the client is entering into the joint venture with the anticipation that the other party will dedicate specific technology to the joint venture on an exclusive basis the documentation should include a clear and enforceable assignment or exclusive license of the technology to the joint venture. The same goes for any other "complimentary strength" that the client is pursuing from the other party: the documents need to commit the other party to providing the desired and expected capital, technology, physical assets and human resources.

4. What paths should be created for exiting the joint venture?

While discussing "exit mechanisms" with the client so early in the conversation may seem counter-intuitive, if not downright dangerous when the client is so enthused about the new relationship, the fact of the matter is that most joint ventures end within five to seven years, sometimes by cessation of the business by mutual agreement but more often by one party buying out the other and continuing the business formerly conducted by the joint venture. Disengagement from a joint venture does not necessarily mean that it was not successful; however, "breaking up is hard to do" even in the best of circumstances and both parties should be advised that taking the time to establish clear and objectively administrable exit mechanisms at the beginning of the joint venture is much preferred over long and expensive fights at a later date.

The first question, of course, is what the client has in mind for a specific term for the joint venture. A joint venture organized as a separate legal entity can extend for as long as the law permits for the particular entity; however, a joint venture is typically formed and operated for a limited purpose and thus the participants should have some reasonable idea of how long it will take to achieve the purpose. Setting a specific term does not eliminate the issue of how both participants should exit the joint venture once the date is looming but it does frame the discussion about how the participants should go about unwinding what has hopefully been a successful collaboration.

Most of the time on this issue is spent thinking about what should happen if a participant wishes to exit the joint venture before the end of any specified term. The attorney needs to discuss several different scenarios with the client: sale of the entire business to a third party, in which case it is important to provide for rights of first refusal, "tag-along rights" and "drag-along" rights that would be triggered by a third-party offer; the desire of the client to buy out the other party, which may be established as an option accompanied by a specific price established at the time the joint venture launched; the desire of the client to be able to sell its interest to the other party, which may be incorporated into the deal a right to "put" the interest to the other party on or after a date established at the beginning of the project; or the desire of the client to simply end its relationship with the other party regardless of whether the client continues the business of the joint venture, in which case the attorney may recommend a "cake-cutting" provision that allows the client to specify a price and ask the other party to either buy or sell at that price or consent to a managed dissolution of the joint venture.

Exit rights also come into play when one of the parties defaults in its obligations to the joint venture. The point is that the attorney needs to go through a variety of possibilities with the client and determine the best way to deal with each of them in terms of which party gets to make the first move, how the price will be set for the purchase of the interest of a departing party (e.g., price established in advance; price established by negotiation at the time of departure event, a solution which is not recommended unless accompanied by a means to resolve any deadlocks; formula provisions; or independent appraisals), how the purchase price will be paid and secured if a deferred payment scheme is used and, finally, the rights of the parties with respect to tangible and intangible assets previously made available to the joint venture and the ongoing obligations of the parties to one another and third parties (e.g., guarantees, warranties etc.) after they have parted ways.

5. How should the joint venture be structured?

The parties to a joint venture rarely dispense with forming at least one new entity to conduct the business of the joint venture for both tax and liability reasons. As mentioned above, corporations, partnerships and limited liability companies are among the choices available to prospective joint venture participants and limited liability companies have clearly become more and more popular given their advantages in terms of providing the participants with limited liability, pass-through tax treatment and more flexibility with respect to allocation of tax items. Each of the parties seek to achieve the business objectives identified earlier in the conversation in a manner that is efficient from a tax perspective and which does not create unnecessary risks and potential liabilities for the rest of their businesses. When selecting the type of business entity consideration should be given to the state of incorporation/organization since state law dictates the applicable default rules and the breadth of flexibility that the parties have with respect to crafting their own terms of engagement. For the non-tax specialist advising clients on joint ventures the "structuring question" is the cue for suggesting a detailed tax and accounting analysis of the proposed business plan for the joint venture including the manner in which tangible and non-tangible assets are contributed and how income and expenses arising during the operation of the joint venture will be treated.

6. How will the joint venture be capitalized?

As mentioned above, a joint venture is a new business and like any new business it needs access to financing in order to be effectively launched and to survive until the point where it is able to sustain itself from cash generated from internal operations. In general, financing for a joint venture is a bit different than a "start-up" since, in most cases, the participants in the joint venture have sufficient capital to underwrite the project and/or are able to convince commercial bankers to provide capital to the joint venture entity directly if guarantees of the participants are provided. The attorney should determine whether the participants have prepared and agreed upon a budget that reasonably anticipates if and when outside capital in some form will be required. Once that has been completed, decisions need to be made about how initial contributions, as well as projected future contributions, of cash should be made: equity, debt, preferred shares, or a combination. Procedures for cooperating on negotiations with commercial lenders should be included in the documentation. Things get complicated when a participant is contributing property and/or services for which "credit" will be given in the form of an increase in the participant's overall ownership percentage in the joint venture which, in turn, impacts the participant's voting rights and allocations of profits. Provision should be made for independent valuation/appraisal of non-cash contributions and the non-contributing participant should carefully monitor whether the agreed contribution has been made in the manner anticipated at the time the documentation was finalized. Finally, in situations where capital contributions are to be made in tranches, or the documentation explicitly contemplates that additional capital calls may be made, the parties should agree in advance on penalties for breaches and defaults. In other words, the client should be asked what it expects should happen if the other party fails to make an expected cash contribution one year into the joint venture. Possible solutions in that case include having the client make the contribution itself with an adjustment of ownership percentages, bringing in another party to the joint venture or unwinding the joint venture with penalties for the other party.

One interesting scenario for the formation of a new joint venture contemplates that one or both parties will "contribute" significant pieces of their existing businesses, such as whole operating divisions, to the joint venture. In that instance the deal takes on many of the aspects of an "M&A" transaction with contribution agreements between the participants and the joint venture entity that look much like an asset purchase agreement with extensive representations and warranties, asset lists, indemnities with negotiated baskets and limits and debates about how accrued benefits of employees working in a contributed division will be funded and paid.

Even when an entire division, including all or most of its existing employees, is not being contributed to a new joint venture the attorney should ask the client about how the new joint venture will be staffed and, in particular, whether any of the client's current managers and employees will be transferred to the joint venture. Personnel transfers may be inevitable and, in fact, are often a key factor in making the joint venture successful; however, the client, as well as the other party, should make sure that the transferees understand their roles and are not professionally and economically disadvantaged by moving to the joint venture.

7. What should be the formal "scope" of the joint venture?

It is common for the participants in a joint venture to prepare a statement of the intended "scope of activities" of the joint venture that is included in the documentation and also serves as a reference point for defining the limits imposed on other activities of the participants and the use of technology shared with the joint venture under licensing arrangements. By the time that the attorney gets to the specific discussion of the scope of the joint venture much of the thinking has already been done as the client has hopefully laid out its ideas about its business objectives, the expected contributions of the other party and what the operating joint venture should look like down the road once it is up and running. At this point, the attorney needs to understand whether the client anticipates extending the relationship between an initial limited purpose to include additional contributions of capital and/or technology or expansion of the relationship into other functions, products or markets. The scope of the joint venture is also relevant to whether the participants will be constrained in their independent activities. For example, the attorney should ask the client whether it expects that the participants will be restricted from entering into other businesses in a particular area without first offering opportunities associated with those businesses to the joint venture. Future disputes about whether or not a participant is fully devoting its attention and resources to its joint venture obligations will almost certainly doom the relationship to failure.

8. What needs to be done in order to get the joint venture up and running?

This is the point in the conversation where the client tells the attorney that the joint venture needs to be set up by a certain date, often totally unrealistic, and the attorney responds with a list of things that may need to be done before the joint venture the switch can be turned on for the joint venture. A number of factors go into the timetable for launching a joint venture including the size and complexity of the proposed relationship and the amount of time that the client has already spent getting to know the other party and conducting due diligence. In any case, the attorney and the client need to discuss whether any tax or other regulatory requirements need to be satisfied prior to launching the business; when and how the assets to be used in the joint venture will be contributed; the need for third party consents (including consents from third party to use technology that they have licensed to one of the participants in the joint venture); and the time required to negotiate and draft licensing, employment and other agreements. Another thing to consider is how the joint venture will be operating during its initial stages as it slowly ramps up to full and independent capacity. In many instances one or both of the participants will provide short-term assistance under services or management agreements that address provision of overhead services to the joint venture. These arrangements may be extended to include core functions such as sales and distribution until such time as the joint venture is able to carry those activities on its own with in-house personnel. The attorney should commit to creating a schedule and timetable that includes all the actions that need to be taken to get the joint venture up and running and should make sure that counsel for the other party, and his or her client, are on board with the proposed path to closing of the deal. In fact, to avoid misunderstandings and flush out any issues that may not have been discussed by the participants in their preliminary meetings, the attorney should suggest that everyone work on putting together a memorandum of understanding or term sheet that lays out the answers to all of the questions in this "Top Dozen" list, including those that follow regarding key issues such as management and dispute resolution, and incorporates a list of all the key conditions that need to be satisfied in order to launch the joint venture.

9. How will the joint venture be managed?

Management of a joint venture is obviously one of the central issues for the participants and a much fuller discussion of management structures and ideas for dealing with questions such as the composition of the board of directors and voting on major decisions follows below. At the outset, however, the attorney needs to understand how his or her client views its participation in oversight of day-to-day operations of the joint venture and identify the areas as to which the client needs and wants control or, at the very least, the right to block any actions that might be proposed by the other party and/or managers of the joint venture selected by the participants. It is not necessary for a party to have the right to designate a majority of the board members in order to exercise control over the joint venture; however, if the client cedes control of the board to the other party it needs to be sure that it has access to information about joint venture operations and advance notice of any

matter that the client considers to be of crucial importance.

While, once again, alternative management and control structures are discussed below, the common scenario is for one of the participants to have day-to-day operating responsibility, generally the party with the greatest expertise in the main functional activities of the joint venture (e.g., sales-focused joint ventures will typically be managed by the party with experience selling and distributing products in the specific markets chosen for the joint venture activities). The responsibility authority of the party with respect to routine decisions about the joint venture is tempered, however, by veto rights in favor of the other party over a long list of "significant matters" including changes to the various agreements used to organize and structure the joint venture, sale of all or certain assets, deviations from the agreed strategic plan and budget, incurrence of debt over a certain amount, admission of new participants, any change of control of an existing participant, affiliated party transactions, compensation arrangements with joint venture managers, change of accounting methods, extraordinary distributions, etc.

Beyond the significant matters mentioned above, the participants should decide, in advance, on most of the key aspects of the corporate governance structure. This means designating the initial board members in advance and determining how the initial officers of the joint venture will be selected, reviewed and, if necessary, replaced. Independent auditors and legal counsel for the joint venture should also be selected in advance and both of the participants should have confidence that the financial condition and transactions of the joint venture will be properly audited and that clear and complete information regarding joint venture operations will be readily available.

Interesting sub-issues with respect to management of a joint venture are discussed in more detail below; however, the attorney should determine whether the client believes that the joint venture CEO/president will be recruited from outside the personnel pool of the participants and, if so, whether that person would be invited to join the board of directors. The attorney should also mention that possible use of various board committees include audit and compensation committees performing roles similar to those found among public companies and/or subcommittees focusing on technical and/or functional activities such as research and development, manufacturing or sales/distribution.

10. What rules should be established regarding cash and other distributions?

As with any business the participants in a joint venture need to determine how to manage the cash that is generated by the operations of the business. Assuming that the participants select a tax pass-through vehicle for the structure of the joint venture, such as a partnership or a limited liability company, some provision should be made for minimum distributions of amounts that are needed by the participants to cover income taxes associated with their interest in the joint venture. Beyond these "tax distributions," however, the issue comes down to achieving the appropriate balance between returning capital to the participants and retaining sufficient cash to establish a reserve that would be available to cover unforeseen expenses and perhaps fund expansion of the activities of the joint venture. The amount of cash available for distributions should be tracked against projects in the strategic plan and budget agreed upon by the participants at the beginning of the joint venture. Attorneys advising their clients on distribution issues should counsel them to retain close control over distributions beyond those needed for taxes and require that meetings be held no less frequently than annually to specifically analyze the cash flow position of the joint venture.

11. What rules should be established regarding resolution of disputes and deadlocks between the participants?

While, hopefully, the participants will establish a management structure that facilitates a smooth relationship and allows them to efficiently reach decisions about how the joint venture should be operated the reality is that participants in a joint venture will inevitably reach a point where they simply cannot easily agree on an important matter. Dispute resolution procedures are so important that they are discussed in more detail below; however, at a minimum the attorney needs to ask the client to think about what should happen if an impasse occurs and, even more specifically, think what three or four potential conflicts are most likely to arise and how important they are for the client. In some cases a disagreement over a particular issue, such as a major change in the strategic plan for the joint venture, is so important that the client will want the ability to exit the joint

venture using one of the procedures already discussed above. Even in those circumstances though it is best not to move too hastily, although extended periods of conflict among the participants will inevitably harm the progress of the project regardless of whether and how the conflict is ultimately resolved. Common practice is to provide for several progressive levels of dispute resolution starting with "good faith" negotiations and then moving to discussions between senior executives of both participants before turning to intervention from outside parties through mediation and/or arbitration.

12. Is there anything in the "boilerplate" that requires special attention?

By the time that the attorney gets to the last of the "Top Dozen" weariness on both sides of the conversation will likely have set in; however, the skilled business counselor understands that what many refer to as the "standard" or "boilerplate" provisions in the joint venture documents include potential landmines and opportunities. Many of these provisions become extremely important in the event that problems arise: arbitration or litigation, choice of law and forum and rights to attorneys' fees as part of a favorable resolution of a dispute. Consideration should also be given to how each of the participants is required to handle and protect confidential information of the other received during the period leading up to the beginning of the joint venture and throughout the relationship. The client may also want assurances that the other party will not solicit the client's managers and employees and time should be spent discussing the need to push for the adoption and enforcement of codes of conduct and conflicts of interest policies. The attorney should create a list of all of the provisions that would normally go into the joint venture documents and go through it efficiently with the client to see if any questions or concerns jump out. If they do, the attorney can invest a little more time in explaining why the provision is included and what underlying legal and business issues should be considered.

Once the "Top Dozen" discussion is completed the attorney should circle back with the client to see if any that was covered triggered additional questions for the client regarding the scope and purpose of the joint venture and/or the specific party that has been identified and selected as the business partner. While business issues are, of course, the province of the client a trusted business counselor can provide value by framing those issues a bit differently and by eliciting information from the client that the attorney can use to draft documents that make a real contribution to the success of the joint venture. As mentioned above, the issues included in the "Top Dozen" can be memorialized in a term sheet or letter of intent that can be used to ensure that both parties are synchronized on what will be taking place. The "Top Dozen" also inevitably adds some items to the client's due diligence list and helps build out a schedule for completing the deal. Each deal is different and unique; however, using the "Top Dozen" technique is a tried and tested way to help clients focus on their goals and design a joint venture structure that has a greater chance of being successful.

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Footnotes

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