The Art and Science of Creating a Successful Joint Venture

Uri Doron, Partner (Corporate), Jenner & Block
Brian Fischer, Partner (Litigation), Jenner & Block
Tammy Brandt, Chief Corporate, M&A and Alliance Counsel, CSC
Jason Garbell, BioAg Alliance Lead, Novozymes

September 28, 2016
What is a Joint Venture (Business Perspective)?

• JVs can take a wide variety of forms
  – Teaming agreements / teaming arrangements
  – Patent pools
  – Joint development agreements
  – Alliance agreements
  – Cooperatives
  – Jointly-owned entities (e.g., LLCs, corporations, etc.)
Structuring Considerations – Equity vs. Non-Equity

- JVs can be equity or non-equity arrangements

- **Equity**: JVs as a type of equity arrangement involving the formation of separate entity, operated as separate business, negotiated combination of assets and resources

- **Non-Equity**: Contractual arrangements governing joint efforts on licensing, R&D, manufacturing, sales and distribution, investment, etc.

- Unincorporated or pure contractual commercial joint ventures should be evaluated and documents crafted to avoid any unintended “tax partnership” treatment.

- For tax partnership JVs, consider not only sharing of income and positive cash flows but also the potential for losses and how losses will be shared. Losses flow to members currently and do not “build-up” net operating loss carryovers within the JV.
Structuring Considerations – Equity JVs: Populated vs. Unpopulated

• **Populated**: JV hires employees, leases space, owns equipment, has separate operational existence, etc.
  – Can be easier to determine control and points of contact; avoids further negotiation of subcontracts

• **Unpopulated**: JV exists as a shell entity; JV partners provide employees, facilities, equipment, etc. as subcontractors to the JV
  – Often difficult to determine “who is in charge”; easier to establish, but subcontracts must still be negotiated
Entity Selection for Equity Joint Venture

• Corporation
  – C-Corporation: liability limited to amount of investment; subject to taxation at corporate level (when earned) and stockholder level (when distributed); unwinding event is also generally taxable absent consolidation or tax-free split-off
  – S-Corporation: liability limited to amount of investment; when election is made, taxed as “pass-through” at stockholder level; numerous limitations on number/type/residency of stockholders often make election impractical

• Partnership
  – General Partnership: partners participate in management; unlimited liability for debts/obligations of partnership
  – Limited Partnership: limited partners cede management rights, but limit liability to amount of capital commitment

• Limited Liability Company
  – Most commonly-used entity in joint ventures
  – Combines limited liability of corporation with flexible management and capital structure
  – U.S. LLCs with multiple members can elect to be treated as “pass-through” for tax purposes
New York Court Definition of Joint Venture

- Joint venture exists where:
  - Agreement to carry on venture for profit
  - Intent to be joint venturers
  - Contributions of financing, skill, knowledge, or effort
  - Mutual control, at least to a degree
  - Sharing of both profits and losses

- Absence of one of these factors is fatal

- Other jurisdictions with very similar formulations
Key Implications of Joint Venture Status

• Fiduciary duties

• Joint liability to 3rd-parties

• Intellectual property issues

• Obligations akin to those of a partnership—though for a limited purpose

• Note contrast to ordinary arm’s-length contract between sophisticated parties
“Is This A Joint Venture?”

- Abundance of case law
- Express or implied; written or oral


Disclaiming Away the Status

• Disclaimers of joint venture status
  – Strong evidence
  – But not conclusive

• Disclaimers of specific fiduciary obligations
  – More effective
Asset and Capital Contribution

- Contributions can be cash, non-cash assets and/or services or combination of any of the above, with different parties providing varying measures of each
  - Valuation of non-cash assets
    - Services
    - Know-how / expertise
    - Goodwill
  - Tax considerations for in-kind contributions
  - Outside financing

- When venture will be formed by contributions of significant pieces of existing businesses of parties, such as operating divisions or other assets, documentation may mirror M&A transaction and require customary representations, warranties, asset lists, indemnities, etc.
  - How do you structure the representations? Identical for both sides?
  - Indemnity structure
    - Limitations
    - X-indemnity or by JV?
Asset and Capital Contribution

- As an alternative to upfront lump sum contributions, assets may be contributed as installments or tranches of capital calls over time from members as required by the venture.

- Balancing payments
  - Upfront cash
  - Reduction in profit participation (temporary or permanent)
  - Minimum payments

- Penalties or procedures for breach of future obligations
  - Substitute contributions from other members to venture, with corresponding adjustments in ownership percentages
  - Replacement third-party to finance additional capital calls
  - Unwinding of venture upon breach by any party
Governance and Management

- Decisions by management board composed of JV parties, or independent managers

- Fiduciary duties

- Define extent of management authorities: operational vs. major decisions referred to JV parties

- Voting thresholds for different types of decisions (e.g., consideration of supermajority vote requirements, etc.)
  - Approval of budgets; material acquisitions/disposals, capital expenditures, borrowing; issuance of equity; change in scope of JV business; amendments; transfers of interests; key executive appointments

- Composition and representation on management board: proportionate share of interests or some alternative?
Governance and Management (Cont.)

- 50/50 management board? Deadlock provisions and dispute resolution procedures critical

- Management board voting, meeting, communication and notice procedures

- Access to financial reporting, books and records

- Confidentiality and potential conflicts of fiduciary duties by managers of the JV who are also managers of the JV parties
  - As discussed above, can be limited or waived in LLCs and some corporations

- Minority party protections: supermajority, put or tag-along rights
Joint Venture Duty of Loyalty Litigation

• Heavily litigated area

• Joint venturers owe each other “the finest loyalty and utmost good faith throughout” the venture


Getting the $ Out - Distributions

• Profits reinvested in JV or distributed to JV parties?

• Restrictions on distributions:
  – For set period of time
  – Minimum capital amounts required at JV, or
  – Maximum amounts of distributions

• Distributions can be structured as profits, interest on loans, management/service fees, IP/license fees

• For JVs that are U.S. LLCs, order of distributions and priority can be established that vary from percentage interest in JV
Getting the $ Out - Allocations

• In addition to distributions, the JV must separately allocate profits and losses to the JV parties.

• Allocations determine income and loss recognized by JV parties for tax purposes.

• The JV will generally create capital accounts for each JV party under tax accounting rules providing a safe harbor for respecting profit/loss allocations (Treas. Reg. §1.704-1).

• As JV parties are taxed on LLC income whether or not income is distributed, the Operating Agreement will often provide for tax distributions to cover taxes on any allocated taxable income (which can be treated as advances on general distributions or ignored for that purpose).
Intellectual Property – Business Considerations

• Formation of JV
  – IP rights contributed to JV from JV parties or (sub)licensed by JV from JV parties
  – IP disclosure to JV or between JV parties; scope of use; retained rights by JV parties
  – Warranties or indemnities as to ownership and non-infringement required?
  – Valuation of contributed IP rights; are contributed IP rights received only by JV, or other JV partners?

• Operation of JV
  – Ownership and use of IP created by JV: vesting in JV (likely default rule) or JV parties?
  – If JV parties are to retain (co-)ownership, must provide for identification and transfer of rights to JV
  – Access by JV to newly created IP of JV parties
  – Can JV parties use IP to compete with the JV?
  – Who enforces IP rights/defends against third-party IP claims?
Intellectual Property (cont’d)

• Upon termination of JV
  – How is JV-owned or JV-licensed IP distributed/transfered to JV parties?
  – Different mechanisms for each type of exit scenarios (default of one party, withdrawal with ongoing JV)
  – Triggers for termination of IP licenses based on permitted withdrawal or acquisition/sale of a JV party
  – Litigation scenarios

• Competitive/anti-trust concerns may dictate IP arrangements

• IP treatment must align with other arrangements between the parties, including employee arrangements
Joint Venture IP Implications

- Specifying protections over pre-existing IP crucial…but it’s not a panacea
  - *Wellogix, Inc. v. Accenture, L.L.P.*, 716 F.3d 867 (5th Cir. 2013)
M&A

• Transactions by the parties
  – Disclosure of opportunities between the parties
  – Coordination of M&A efforts?
  – Future treatment after completion
    • Sharing in the new business
    • Reasons not to participate

• Transactions by the JV itself
  – Decision making (veto rights?)
  – Funding (obligatory?)

• Valuation methods
Change of Control

- Defining the concern correctly
- Any change of control or just upon sale to competitors?
- Staying clear of unintended consequences
- What are the remedies?
- How detailed is the solution?
Term and Exit Opportunities

• Scope of JV may establish set date for termination

• Additional triggering events:
  – Achievement of (or failure to achieve) operational targets
  – Management deadlocks
  – Default by one of the parties
  – Third party offers to purchase

• Additional Exit opportunities:
  – Sale to third party (or IPO)
  – Termination and liquidation

• Voting thresholds for exit events: majority, super-majority, unanimous; veto rights, etc.?

• Once JV terminated, important to see to subsequent dissolution of JV entity
Transfer of Interests

• Pre-emptive rights
• Liquidity provisions
• Permitted/prohibited transfers
• Rights of first refusal/offer
• Tag-along and drag-along rights
• Shotguns/buy-sell arrangements
• Valuation methodology
Contractual or Entity-Based - Third Party Liability Considerations

- Contractual JVs provide parties with **maximum flexibility** to address and allocate potential liabilities between the parties

- Even in the absence of a contractual relationship with an end-user or customer of the JV’s products, a party may still be liable for **product liability claims** or **breach of contract claims** based on an implied agency theory

- To minimize potential liability, parties should:
  - Consider **different corporate structures** (e.g. use of holding companies) to isolate liable entities
  - **Avoid being deemed as an agent** of the party in contractual privity with third parties
Anti-Trust and Competitive Concerns

• Joint ventures are governed by the civil provisions of most anti-trust statutes
  – U.S. “rule of reason” test: does the arrangement substantially harm competition?
  – Facts-driven analysis
    • Whether agreement likely harms competition by increasing the ability or incentive to profitably raise price above or reduce output, quality, service, or innovation below what likely would prevail in the absence of the agreement
  – Cease and desist order common remedy; fines/injunctions for non-compliance; disgorgement of profits also possible

• Careful analysis may be needed for non-U.S. jurisdictions; for example, even an unpopulated U.S. JV could trigger foreign anti-trust filings or require careful coordination with non-U.S. anti-trust authorities

• Potential U.S. filings include premerger notification by all JV parties to FTC/DOJ on HSR form; if needed, would require 30-day waiting period or early termination of same prior to consummation of JV transaction
Anti-Trust and Competitive Concerns (cont’d)

- US authorities will usually not challenge a JV between competitors if the collective market share of the JV and its partners accounts for ≤ 20% of each relevant market in which competition may be affected.

- The JV Agreement must not include, and the JV must not be a platform to engage in, any price-fixing, bid-rigging, customer allocation or territorial allocation.

- The parties should refrain from exchanging competitively sensitive information, such as cost or pricing data.

- The parties should explore whether or not they are eligible to file a notice of JV, which would limit the risk of antitrust damages to single (instead of treble) damages and avoid any obligation to pay a plaintiff’s legal fees.

- Per European rules, the parties must assess whether or not the JV has an anti-competitive object or actual or potential restrictive effects on competition.