Structuring Join Ventures: Building a Solid Governance Foundation for Strategic Alliances

Submitted by:

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Introductory Points

1. The purpose of this presentation is to provide an overview of joint ventures, particularly management structures, restrictive covenants, transfer restrictions, minority protections, and exits and terminations.

2. This presentation is not intended to provide an in-depth legal analysis of all issues (and minutiae) that may arise out of, or relate to, joint ventures; rather, it is intended to provide an overview of the many issues that JV participants encounter in negotiating, drafting, and entering into JV agreements.

3. If there are multiple JV entities (including subsidiaries of the main JV entity), the parties should consider which concepts should apply to those other JV entities, including consent rights, preemptive rights, and transfer restrictions.

4. Much of the information described in this presentation is based on Delaware law. If the JV will be organized in a state other than Delaware, please check the relevant state's corporate, partnership, or limited liability company statute, as applicable, depending on the JV’s entity type.

5. This presentation will not discuss (a) transfer restrictions under applicable U.S. securities laws or (b) antitrust laws, which potentially may apply to certain JVs.

6. Although there is a lot of information covered in these written materials, we will not necessarily be discussing each point. These materials are designed to be used by you in your day-to-day work as a reference source.

7. Of course, if you have any questions, or if there is anything in these materials you would like to discuss, please feel free to call or email me.
Overview

1. A JV is an entity created by two or more parties to pursue a specific business, where each party contributes key assets or capabilities to the pursuit of the joint enterprise. Typically, two (and sometimes more) parties contribute assets, expertise, employees, or services to a newly formed entity operated for the parties’ benefit. While the basic premise is simple, structuring and, more importantly, operating a joint venture can be anything but straightforward.

2. Companies may enter into a joint venture for a variety of reasons.

   - JVs may be viewed as a lower-risk way to enter into a new line of business than doing so organically—particularly if one JV party brings knowledge of that business to the venture—or a cheaper alternative to doing so by acquisition.
   - Each JV party may bring expertise to the JV that the other lacks, or one JV party may bring expertise while the other brings capital.
   - In cross-border joint ventures, one JV party may bring operational expertise, while the other brings local market knowledge and contacts.
   - There may be cost savings from (i) combining certain of the JV parties’ assets and (ii) achieving economies of scale by combining the JV parties’ purchasing power.
   - In many regulated industries, such as energy and telecommunications, a company looking to grow in a particular market may be required by local ownership requirements to take on a local partner.

3. JVs often are complicated arrangements intended to last for a long, if not indefinite, time. To ensure the success of the JV over its life, the parties must design a mutually acceptable framework that enhances their ability to work together to successfully carry out the JV’s purpose. Any tilting of control too heavily in favor of one JV party over another can sometimes lead to an erosion of trust that, over time, affects the JV parties’ ability to work together to successfully execute the JV’s business plan.
## Choice of Entity

<table>
<thead>
<tr>
<th>Entity Type</th>
<th>Equity Holder Limited Liability</th>
<th>Flexible Management / Governance</th>
<th>Favorable Tax Treatment ¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation</td>
<td>Yes</td>
<td>No, board-managed</td>
<td>No, entity-level taxation</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>Limited partners (not general partner) have limited liability; however, under some state statutes, a limited partner involved in the partnership's management may lose its limited liability status.</td>
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<tr>
<td></td>
<td></td>
<td>No, general partner-managed, with co-venturers typically appointing representatives to the general partner's managing board.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Yes, pass-through tax treatment</td>
<td></td>
</tr>
<tr>
<td>Limited Liability Company</td>
<td>Yes</td>
<td>Yes, limited liability companies may be managed by one or more members, a manager (including an outside manager), or a board of managers.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Yes, pass-through tax treatment (but can elect entity-level taxation)</td>
<td></td>
</tr>
</tbody>
</table>

¹ Although JVs can be formed in pass-through or corporate entities, initial choice of entity classification is important because any future changes may result in significant tax liabilities.
Management

Overview

1. Many joint ventures are adopting governance practices developed by public companies to address public company governance concerns. However, because the role of the board of directors of a public company is not directly analogous to the role of the governing body of a joint venture, various safeguards that are widely used by public companies may not be necessary in the joint venture context.

- Other than voting for directors, stockholders of a public company generally do not participate in the company’s management. Instead, the board of directors acts on behalf of a disaggregated body of stockholders to develop and implement the company’s business strategy.

- For public companies, board committees, independent directors, and codes of conduct are vital tools that help ensure informed and efficient decision-making and also protect stockholders from potential self-dealing by insiders.

- By contrast, in a joint venture, the JV parties typically appoint board representatives, and the board develops and implements the JV’s business strategy based on direct input from the JV parties.

- The need to resolve disputes among the JV parties is the principal governance problem most JVs face.

- Independent directors, committees, and codes of conduct can be helpful tools in this context, but they should be used in a way that considers the JV’s specific needs.

2. Modification or Elimination of Fiduciary Duties

- Under Delaware law, a corporation may eliminate the fiduciary duty of care but not loyalty (8 Del. C. § 102(b)(7)).

- LLCs and partnerships allow for more flexibility in structuring governance and management. While laws vary by state, LLCs formed in Delaware can modify or eliminate the members’ and managers’ fiduciary duties, other than the implied covenant of good faith and fair dealing, which is relatively narrow (6 Del. C. § 18-1101(c), (e)).

- To ensure elimination of any fiduciary duty, the wording in the JV agreement must be unambiguous (see Fisk Ventures, LLC v. Segal, 2008 WL 1961156, at *10 (Del. Ch. May 7, 2008)).

- Many sophisticated JV parties replace default DE common law fiduciary duties that otherwise would apply with specially negotiated contractual rights set out in the LLC’s operating agreement.
  - A majority JV party may be unwilling to agree to substantial minority protections, while it (or its board appointees) remains subject to potential claims for breaches of fiduciary duties.
  - A party may expect its board representatives to act exclusively in its best interests, but unless fiduciary duties are waived, board members will owe fiduciary duties to the company and its members, not just the member that appointed them.
  - While some waivers may be beneficial to a minority JV party (such as a waiver of fiduciary duties that allows its board representatives to act in the minority JV party’s self-interest), generally speaking, a minority JV party only should agree to waive a...
majority JV party’s fiduciary duties if it (I) has sufficient contractual rights and protections in the LLC agreement to compensate for the loss of fiduciary duty protections and (II) is confident in its and, if applicable, its board representatives’ ability and level of sophistication to exercise these rights.

3. **Management Structures**

- As previously mentioned, corporations are managed by their boards of directors, and limited partnerships are managed by their general partners (with JV parties typically appointing representatives to the general partner’s governing body).

- The members manage a Delaware LLC, unless the LLC agreement provides otherwise (6 Del. C. § 18-402). The members may delegate to one or more persons “any or all” of their “rights, powers, and duties to manage and control the business and affairs of the limited liability company” (6 Del. C. § 18-407).

- Because of the flexibility afforded by Delaware law, LLCs may be managed by (A) an outside manager, (B) co-managing members, (C) an operating member, subject to other members’ approval of major decisions, (D) an operating member, subject to board approval of major decisions, and (E) a board of managers.

- The remainder of this section will discuss these LLC management structures. However, many topics covered in this section also will be relevant to JVs formed as corporations or partnerships.

**Non-Member Manager**

- In this structure, the members hire a non-member manager to run the venture.

- The JV agreement will need to set forth (i) the circumstances under which, and the process for, removing and replacing the non-member manager and (ii) the non-member manager’s rights and responsibilities, including how much time the manager must commit to performing its duties as manager, restrictions on its activities outside the JV, and the manager’s specific performance standards or obligations.

- This could be an attractive option when (i) the members prefer to be passive investors, (ii) the JV’s purpose or business plan is narrowly focused, (iii) none of the members have sufficient expertise in the JV’s business or industry to manage the JV, and/or (iv) management of the JV requires operational or commercial expertise rather than strategic decision making.

**Co-Managing Members**

- In this structure, the members manage the LLC directly.

  - In a two-member LLC, decisions may require the unanimous approval of both members. In a LLC with more than two members, separate categories of decisions may require majority, supermajority, or unanimous approval of the members.

- In this structure, clearly delegating authority for day-to-day and other ordinary course tasks is particularly important; otherwise, the JV’s business can be impaired if a member is not responsive or loses focus on its role in the JV’s management.
Operating Member as Managing Member Subject to Investor Member Approval of Major Decisions

- This management structure gives one of the members (the “operating member”) authority to manage the venture’s day-to-day business, subject to obtaining approval of certain high-level decisions by the other member (the “investor member”), in a two-party JV, or a majority, supermajority, or other specified percentage-in-interest of the investor members, in a JV with more than two parties.

- The investor member may have the right to assume control of the venture, or to remove the operating member as the managing member and to appoint a replacement manager, if (i) the venture fails to achieve a specified milestone in its business plan, or to generate a minimum stated return on the investor member’s invested capital, by a specified date or (ii) in the event of a material, uncured breach of the operating member’s obligations under the JV agreement.

- This management structure may be useful:
  - to reduce the risk of deadlock with respect to routine matters that are not subject to the investor member’s veto rights;
  - when there is an initial period requiring quick decision-making and intensive, hands-on management, such as in an early-stage JV seeking to develop a new technology; and/or
  - when the operating member has specialized expertise the investor member is relying on to execute the JV’s business plan, in which case the investor member may not want its involvement in decision making to dilute the operating member’s responsibility for achieving the JV’s business plan.

Operating Member as Managing Member Subject to Committee Approval of Major Decisions

- In this structure, the authority to manage the JV is vested in the operating member, with the operating member being required to seek the approval of a committee that typically consists of representatives appointed by the investor members (often senior executives or controlling parties of the investor members).

- The committee may be referred to by a variety of different names, including an advisory board, executive board, advisory committee, executive committee, or governance committee.

- This structure may work well where there are a larger number of JV parties, including some who hold relatively small percentage interests.

- A committee may make it easier to sustain (A) any necessary communication among the investor members (through their committee representatives) and (B) continuity of dedicated representatives over the term of the JV.

- This structure also may facilitate greater collaboration among the members (indirectly through their dedicated representatives on the committee).

  - If the investor members are large companies, having a dedicated committee representative may (I) increase responsiveness and accountability in decision making, (II) facilitate more efficient dialog and closer collaboration with the operating member, and (III) allow for closer oversight of the operating member by the investor members’ representatives, if desired.
Board of Managers

Overview

- In this structure, the JV is managed by a board of managers, which may delegate responsibility for day-to-day management of the JV to one or more officers.
- The parties’ board representatives usually are affiliated with the JV parties, such as their senior executives or other staff who are involved in, or familiar with, the JV’s business.
  - If board designees are senior level executives with significant responsibilities to the members’ businesses outside the JV, they may rely on a management team to operate the JV’s business on a day-to-day basis (within the scope of authority the board delegates to management).

Board Size / Composition

- The board’s size usually depends on the number of JV parties, as board representation typically is proportionate to each member’s ownership interest (e.g., a JV party that holds 40% of the JV interests may have the right to designate two of five board members).
  - The number of appointees a minority JV party is entitled to appoint may not be the most crucial consideration if, for example, the vote of its appointed board member is required to approve certain major decisions.
  - However, even if a minority JV party does not have any board-level veto rights, having at least one board representative allows it to participate in, and possibly influence, board-level discussions and decisions indirectly.
- In general, the JV party, with the right to designate one or more board members, typically has the exclusive right to remove and/or replace such board member(s) upon written notice to the other JV parties.
  - Appointment / removal rights may be conditioned upon the applicable party maintaining a certain level of ownership interest.
- Although some JV parties may be uncomfortable with giving a tie breaking vote to an independent manager, if the joint venture is particularly large or has multiple partners, or may go public in the future, the parties may want to consider having independent directors. Using independent directors may help:
  - provide industry, technical, or management expertise that the JV parties lack and need;
  - elevate the JV’s stature or credibility by appointing industry experts or other prominent persons to the board;
  - resolve conflicts among the parties, especially if the parties have equal voting control and there is a risk of deadlock over certain issues;
  - representing the collective interests of smaller members whose individual ownership stakes do not entitle them to appoint their own representatives to the board; and
ease the JV’s transition from a private company to a public company if the JV decides to undertake an initial public offering, as applicable rules and regulations typically require the inclusion of independent directors on public company boards.

- Depending on the type of JV entity and its governance structure (e.g., a corporation or a board-managed LLC subject to fiduciary duties), a minority JV party, in considering whether to negotiate for one or more board seats, should consider whether it wishes to internalize the risks associated with appointing a board member, including possible unwanted exposure to the JV’s trade secrets or proprietary information resulting from board-level discussions and potential exposure to a claim for breach of fiduciary duty or aiding and abetting a breach of fiduciary duty.

**Meetings; Quorums; Voting Requirements**

- Parties should consider whether the board will have regularly scheduled meetings (and, if so, how often) or whether the board will have discretion to decide when to meet.
  - Depending on the JV’s purpose, JV agreements often require the board to meet monthly or quarterly, so that the parties have a forum to maintain an ongoing dialog regarding the JV and its businesses and operations.
  - Alternatively, the parties may prefer that committees (rather than the full board) meet on a more frequent basis, with the full board meeting annually or semiannually.

- Parties also should consider (A) whether meetings may be held telephonically or, alternatively, whether meetings must be held in person (and, if so, where) and (B) who may call, and the procedures for calling, special meetings.
  - While some JV parties may prefer that regular meetings be held telephonically (to avoid the expense and inconvenience of travel), some minority JV parties may prefer in-person meetings to promote more effective dialog and engagement with the majority JV party or the JV’s management.

- The parties have broad latitude to specify the requisite voting thresholds in the JV agreement. The parties may (A) apply the same voting threshold to all board decisions (e.g., unanimous, supermajority, majority of all managers, or majority of managers at a meeting at which a quorum is present) or (B) specify different majority, supermajority, or unanimous voting thresholds for different actions or categories of actions. The express approval of a minority JV party’s manager also may be required for certain actions.

- If a minority JV party has the right to appoint board members, it should seek to ensure that a quorum for the conduct of business requires the presence of at least one of its board representatives. This would ensure that the minority JV party’s board representative participates in board deliberations, even if the representative cannot control the vote. Similarly, minority JV parties also should seek to ensure that their presence is required for a quorum at equity holder meetings.
  - However, a minority JV party’s board appointee could deliberately prevent board action by refusing to attend board meetings. To avoid this potential abuse, a quorum should be able to be achieved at the next consecutive board meeting, even if such appointee again fails to attend. This also should be true for equity holder meetings.

- JV agreements typically allow action by written consent to permit the board to respond to emergencies or unanticipated events and to make conducting business generally easier. If not required to be unanimous, a minority JV party should seek to ensure that actions by written consent require its signature, in the case of equity holder actions by written consent, and the signature of at least one of its board designees, in the case of board actions by written consent.
• If a minority JV party has the right to appoint representatives to the JV’s board, it should review the notice and other procedural provisions regarding board, committee, and equity holder meetings to ensure (A) that sufficient prior written notice is required, especially regarding special meetings, and (B) that its board representative can call special meetings.

  ▪ The majority JV party may seek to limit the number of special meetings that the minority JV party can call, particularly if the majority JV party’s board representatives are senior executives of the majority JV party, with significant responsibilities to the majority JV party outside the JV.

**Committees**

• The parties may decide to delegate certain substantive responsibilities to one or more committees, such as an audit, conflicts, or compensation committee. While these types of committees are usually comprised of employees of the relevant parties, they also may include outside experts with relevant subject matter expertise.

• Committees have a variety of potential benefits, including:

  ▪ If the JV has a large board, committees may streamline governance by delegating responsibility for certain matters to a smaller group of individuals who have a particular interest or expertise in an aspect of the JV’s business.

  ▪ Committees also may be used to promote efficient resolution of disputes—e.g., disputes, which have not been resolved in a timely manner, can be referred to a committee consisting of senior executives of the JV parties who are not actively involved with the JV or, if the dispute is technical or operational in nature, to a committee comprised of technical or operational experts.

    • Tax disputes generally are managed by a “partnership representative.” Care should be taken in granting authority to the partnership representative while still preserving rights for the non-representative JV member(s).

  ▪ Venturers also may use special committees to help resolve conflicts of interest between the joint venture and its members or management (e.g., entry into, or modification of, a related party transaction).

    • If members of the JV’s governing body owe fiduciary duties to the JV and JV parties, such a mechanism, when properly defined and utilized, may shift the burden of proof (or create a presumption of good faith) in the event of a challenge, entitling the board to the benefits of the business judgment rule. However, the JV agreement must carefully define the duties and appropriate standard of review applicable to such a committee.

• As with board meetings, the parties may want to address in the JV agreement the composition of committees, frequency of committee meetings, and quorum and voting requirements.

• In general, a minority JV party, with the right to designate one or more board members, should seek to ensure that at least one of its board appointees participates in each committee with material substantive authorities to protect the efficacy of its manager designation rights.
Restrictive Covenants

1. To protect the JV’s business and to align the parties’ interests, JV agreements may include restrictive covenants that prohibit the JV parties (and possibly their controlled affiliates) from:
   - competing with the JV in its line of business, at least within the JV’s primary geographic territory;
   - soliciting, or otherwise interfering with the JV’s relationship with, the JV’s employees, customers, or suppliers; and/or
   - pursuing corporate opportunities within the scope of the JV’s business or purpose.
     - Even if the JV is organized as a corporation, the parties can provide for a waiver of the “corporate opportunity” doctrine.

2. A JV party that is unwilling to agree to any restrictions on its primary business or other businesses outside the JV—e.g., a large multinational corporation or private equity firm making a relatively small investment in an early-stage JV—generally should seek to include an express disclaimer of those restrictions in the JV agreement.

3. If venturers will be prohibited from competing against the JV or from pursuing corporate opportunities outside the JV, carefully defining the following will be even more important:
   - the nature of the venture’s business;
   - the geographic areas in which the venture operates; and
   - the restrictions, if any, on businesses the venture may conduct.

4. JV agreements also may include confidentiality obligations owed to the JV by the JV parties and the JV’s officers and, if applicable, board members. These provisions, whether intentionally or unintentionally, may effectively restrict such persons’ ability to compete against the JV by prohibiting such persons from using confidential information gained during their participation in the JV for any purpose, other than furthering the JV’s business and operations.
   - If the JV parties would like to avoid this outcome, general industry knowledge should be excluded from the definition of “confidential information” in the JV agreement.
Transfer Restrictions

Overview

• The JV participants’ identities (and what each contributes to the JV) are critical to the JV’s success.
  
  Many JV agreements limit or prohibit transfers of interests by JV parties (other than to affiliates), and where transfers are permitted, a non-transferring party often will (i) seek to control the identity of any new co-venturer, particularly in a situation where the exiting party has any consent rights over management decisions, or (ii) seek to participate in the sale, either by acquiring the transferring party’s interests pursuant to the exercise of a ROFR or ROFO or by selling its interests pro rata to the same transferee pursuant to the exercise of tag-along rights.
  
  To ensure that the parties are committed to (and remain focused on) the JV, transfers to third parties may be prohibited for a certain period (e.g., three years) or until the occurrence of another event (e.g., achievement of an important goal or milestone in the JV’s business plan, whether financial or otherwise).
  
• Parties typically are permitted to transfer JV interests to their respective affiliates without the other parties’ consent to permit the transferring party to (i) carry out any internal restructuring or reorganization that may be necessary for tax or regulatory reasons or (ii) facilitate its ability to sell one or more subsidiaries or assets that are unrelated to the JV.
  
  However, the affiliate transfer provisions may require that the transferor guarantee the obligations of the affiliate transferee and that the affiliate transferee remain an affiliate of the transferor or otherwise reverse the transfer.
  
• Some JV agreements provide more flexibility for a party to transfer its interests to a third party, by:
  
  providing that any consent required from another JV party cannot be unreasonably withheld, conditioned, or delayed, either initially or after a certain period (e.g., three years) or until the occurrence of another event (e.g., achievement of an important goal or milestone in the JV’s business plan);
  
  allowing transfers to permitted third parties, subject to ROFR, ROFO, and/or tag-along rights granted in favor of the non-transferring parties; and
  
  giving a financial investor more flexibility to transfer its JV interest than a strategic JV party.
  
  • Financial investors are less likely to provide important support or services to the JV than a strategic party.
  
• In addition, co-venturers’ rights to transfer interests to third parties oftentimes are conditioned upon the proposed transferees meeting certain criteria, such as the proposed transferee:
  
  not being a competitor of the JV or other co-venturers;
  
  having a minimum net worth or satisfying other stated financial criteria;
  
  satisfying applicable regulatory requirements, especially if the JV operates in a highly regulated industry (e.g., gaming, banking, cannabis, pharmaceuticals, or oil and gas); and
- not being a person (A) to which a transfer would, or reasonably would be likely to, cause a breach of any sanctions or corrupt practices laws or (B) who is, or previously has been, involved in any well publicized allegation of, or who previously was convicted of, any criminal, deceptive, or fraudulent scheme or activity.

Although the remainder of this section may not reiterate this concept as specific transfer restrictions are discussed, this concept, if applicable, likely would apply to all third-party transfers, whether pursuant to a ROFO, ROFR, tag-along right, or otherwise, and if so, the term “third party,” as used in the remainder of this section, would mean a third party transferee who meets the relevant criteria.

- JV parties should consider how the transfer of a party’s interests effects the JV (and, by extension, the non-transferring JV parties), including:

  - If the JV has any debt, whether a transfer of a JV party’s interests triggers a default under any credit agreement with the JV’s lender or whether there are any similar adverse consequences under any of the JV’s other material contracts, such as a lease.

  - How a transfer of a JV party’s interest affects any service, support, IP license, or other agreements or arrangements between the JV and any of its subsidiaries, on the one hand, and the transferring JV party or any of its affiliates, on the other hand.

- Non-managing JV parties should ensure that any such advisory or management services agreements are terminable by the JV without penalty if the managing JV party exits the venture.

- Whether the scope of the definition of transfer (or another similar term) in the JV agreement should pick up:

  - a pledge of JV interests; or

  - an indirect transfer of JV interests, such as through a change of control of a JV party’s direct or indirect parent entity.

- A JV agreement that neglects to address indirect transfers could undermine the transfer restrictions’ effectiveness by permitting changes of control at the parent level.

- However, prohibiting indirect changes of control could be problematic, particularly for any co-venturer (I) who is publicly traded or (II) whose investment in the JV is only a small part of its overall combined business (especially if that co-venturer is solely a financial investor).

- As such, a well-drafted agreement might provide a buyout right of the transferring party’s JV interests but otherwise permit the change of control.

- Exit mechanisms in joint venture documentation may be rendered ineffective by covenants in the JV’s financing agreements. For example, a lender’s standard transfer restrictions may prohibit the sale of JV interests pursuant to a ROFO, ROFR, call right, put right, or buy-sell provision, and unless there will be a refinancing in connection with the transfer (which still could be problematic in the event of a prepayment lockout or premium), the parties may find that the exercise of their exit or buyout rights under the JV agreement is impermissible, when appropriate exceptions have not been included in the financing agreements.
While a lender is unlikely to give co-venturers carte blanche to bring in any successor JV party, the lender may agree to permit one JV party to buy out the other, unless one of the existing JV parties is critical to the JV’s business and operations. In addition, the lender may agree to transfers to third parties that meet certain criteria, as described above.

If a JV party or its affiliate has guaranteed the venture’s debt, the buyout of that JV party pursuant to a ROFO, ROFR, call right, put right, or buy-sell provision will need to be accompanied by a release of the guaranty, if the lender is willing to give one, or an indemnity by the purchasing JV party or a creditworthy affiliate thereof in favor of the guarantor.

In the absence of a provision in the JV agreement to the contrary, an assignment of a Delaware LLC membership interest is presumed to transfer only the JV party’s economic rights (6 Del. C. § 18-702).

The remainder of this section will discuss ROFRs, ROFOs, tag-along rights, and drag-along rights separately, but in practice, well-drafted JV agreements will need to specify the relationship among these transfer restrictions—e.g., by clarifying whether a ROFO or ROFR will apply to a drag-along sale and whether parties electing not to exercise a ROFO or ROFR may still exercise tag-along rights in connection with the same transfer.

**ROFR**

A ROFR gives a selling JV party the ability to sell its JV interests to an identified third party buyer on terms and conditions specified in an agreement, term sheet, or letter of intent between the selling JV party and the third party buyer, subject to the right of the other JV party (or, if there are more than two JV parties, the other JV parties pro rata) to purchase the selling JV party’s interests by matching the terms of that third party offer.

In a JV with multiple JV parties, the JV entity sometimes has the ROFR (rather than the other JV parties) or the other JV parties may have a secondary right to buy their pro rata share of any portion of the selling JV party’s interests not purchased by the JV.

The ROFR allows a non-selling JV party to decide whether to:

- purchase the selling JV party’s interests (on the same terms as it agreed to with the third party buyer); or
- permit the transfer on the disclosed terms and conditions but with the benefit of full knowledge of the transferee’s identity. The ROFR provision sometimes expressly requires the exiting JV party to provide specific information about the third-party buyer, such as regarding its equity holders or controlling parties if it is not a public company.

Regarding pricing, the parties must deal with non-cash consideration in third-party offers, either prohibiting offers with non-cash consideration or providing a mechanism for valuing such consideration. Further, in evaluating a third-party offer under a ROFR that involves the payment of a brokerage commission, the agreement arguably should reflect that such commission may not be payable if the other JV party accepts the offer and, as such, provide for an appropriate sharing of the savings.

A JV party who expects to be in a selling position should be concerned about the chilling effect a ROFR can have on the successful marketing of its JV interests.

- A prospective purchaser may be reluctant or unwilling to expend the resources necessary to complete its due diligence investigation and to negotiate the purchase of the selling party’s...
interests if it knows that it may lose the deal (and the benefits of those efforts) if the ROFR is exercised.

- A prospective purchaser may require a breakup fee from the selling party, which erodes the selling party’s return, unless the JV agreement permits the breakup fee to be passed onto the JV and/or other parties exercising the ROFR.

- The chilling effect may be exacerbated if the time periods for response in the ROFR are too long. A prospective purchaser typically will not want to wait while the JV, the non-exiting JV parties, or both decide whether to match its terms and purchase the selling JV party’s interests.

- If the JV parties have a nonconcurrent, secondary ROFR to purchase any portion of the selling JV party’s interests not purchased by the JV, the third party’s total potential waiting period will be longer.

- This can be addressed by requiring the JV and JV parties to exercise their ROFR rights simultaneously, with each JV party being required to specify, in its exercise notice (which would be delivered at the same time as the JV’s exercise notice), what portion of its pro rata share of the transferred interests it would like to acquire (including a statement that it wishes to acquire the maximum amount of interests potentially transferable to it).

- Conversely, a JV party that wants to effectively limit the other parties’ ability to transfer their JV interests may find the chilling effect advantageous.

**ROFO**

- **Mechanics**

  - A ROFO requires a selling JV party to deliver a first offer notice to the non-selling JV party setting forth the material economic terms upon which the selling JV party would sell its interests to the other JV party (or, if there are more than two JV parties, the other parties on a pro rata basis) before offering to sell them to a third party.

  - The non-selling JV party has a specified period during which it may accept the offer.

  - If the other JV party accepts the offer, the parties proceed to close the sale on the terms stated in the offer notice and as further negotiated between them.

  - If the other JV party elects not to buy the JV interests, the selling JV party then has a limited period (e.g., six to 12 months) to complete a sale to a third party on terms no more favorable to the third party than those offered to the other JV party.

    - However, the selling JV party will be required to re-comply with the ROFO if it does not complete a transfer substantially on the offered terms within the prescribed time period.

  - Unlike a ROFR, no third-party offer is needed for a ROFO. Because the selling JV party does not first have to negotiate a deal with a third party before offering its JV interest to the other JV party, a ROFO generally is considered to be less restrictive than a ROFR.

  - However, the ROFO creates economic uncertainties for the selling JV party, who must set the price without the benefit of a bona fide, third-party offer. A low price likely will result in the selling party leaving some value behind if the ROFO is exercised, while a high price may result in the selling partner being unable to obtain the price required by the ROFO (thus requiring the selling JV party to re-comply with the ROFO after the market sets the price).
From a minority JV party’s perspective, this provision typically is most useful if the minority JV party anticipates having access to the funds or financing necessary to purchase the other JV party’s interests.

**Tag-Along Rights**

A tag along requires the selling JV party to give notice of any sale of its interests to the non-selling JV party. The non-selling JV party may participate by selling a proportionate amount of its interests in the transaction. If the buyer is unwilling to buy all the interests, the selling JV party may, under the JV agreement, no longer be required to complete the sale.

However, if the selling JV party decides to complete the sale, then the tag-along right typically provides for a sale of a pro rata share of each participating JV party’s interests, so that the total interests to be sold equal the number that the third party originally proposed to purchase from the selling JV party.

Tag-along rights often are used in conjunction with other transfer rights and exit mechanisms. For example, a non-exiting JV party may have a right to tag along on the sale of an exiting JV party’s interest if a ROFR or ROFO is not exercised.

**Drag-Along Rights**

Even if sales of JV interests are unrestricted, a sale of a party’s JV interests often is not an attractive exit path, in part because a sale of less than the entire JV likely will involve a discount. In addition, the potential difficulty of locating a transferee who will be willing to live within an existing JV structure complicates a party’s ability to exit a joint venture (or may, at the very least, result in a further discounted price for the JV interests).

As a solution, a controlling JV party (or the holder or holders of a majority or supermajority of the JV interests) may seek drag-along rights. Drag-along rights allow certain JV parties to cause all other JV parties to sell the same portion of their JV interests (generally on the same terms as the dragging JV party or parties) as the initiating holder proposes to sell in the drag-along sale (up to 100% of each JV party’s interests) to a third party transferee. Because a drag-along right allows for the sale of 100% of the JV interests, it eliminates these discounts.

Parties seeking drag-along rights should endeavor to include the following in the JV agreement:

- The ROFO or ROFR, if any, should be inapplicable to a drag-along sale.
- Each dragged JV party should be required to waive dissent rights, if applicable.
- Each party should be required to execute and deliver such documents as are necessary to effectuate the drag-along sale.
- Each party should be required to bear its pro rata share of any reasonable costs and indemnities, other than indemnities relating to breaches of covenants by, or breaches of warranties specific to, another JV party, with reasonable costs being paid out of the aggregate sale proceeds prior to the sale proceeds being remitted to each JV party pro rata.

Minority parties should endeavor to include the following in the JV agreement:

- Each drag-along purchaser must be a third party that is unaffiliated with the parties who have drag-along rights, and the drag-along sale must be an arm’s-length transaction.
Each dragged party will be required to sell its interests on substantially the same terms and conditions as the dragging party or parties, including for same type and per interest amount of consideration.

The drag-along provisions should not require any minority JV party to be bound by confidentiality, non-solicitation, or non-competition covenants negotiated by the dragging party or parties, without such minority JV party’s consent.

If the parties have significantly reduced or eliminated fiduciary duties, a minority JV party should consider requiring (A) drag-along sales to meet certain performance criteria (e.g., a minimum financial return on the minority party’s initial investment) or (B) a robust auction sale process be conducted (to achieve the highest value for all JV parties).

Each minority party’s maximum potential indemnification liability should be capped at the proceeds it actually receives, and no minority JV party should be liable for indemnities specific to another JV party (e.g., fraud by, or breaches of covenants by, or breaches of warranties specific to, another JV party).

**ROFR, ROFO, and Drag-Along Asset Sales**

- A sale of the exiting party’s interests likely will generate less proceeds for the exiting party than its share of the proceeds of a sale of all JV property.

- In a less common variation on the ROFR, one party may obtain a *bona fide*, third party offer for the JV property and present it to the other party. The non-initiating party then has the right to buy the property from the JV on the same terms or buy out the initiating party for the amount the initiating party would receive if the property is sold at the offered price and the JV liquidated.

  - By using the liquidation provision to establish the price, distribution priorities, existing partner loans, and the like automatically are taken into consideration.

- A property ROFR suffers from the same chilling effect on marketing as an equity ROFR.

- A property ROFR also forces the non-initiating party either to buy, which may not be feasible, or to have its interest liquidated when it would not otherwise have desired to do so.

- A ROFO also may be implemented with respect to a sale of the JV’s property. This eliminates both the “chilling effect” and concerns about the transferee’s identity, although it still requires the non-initiating party either to buyout the exiting party or to accept the sale of the property and the liquidation of its JV interests.

- Drag-along rights also may contemplate both equity sales and asset sales.
Additional Minority Protections

Overview

- Without specifically documented rights, a minority JV party may only have basic member, stockholder, or limited partner, as applicable, protections afforded under the law of the JV's jurisdiction of formation. Because JV investments usually are in illiquid, unregistered securities subject to significant transfer restrictions, a minority JV party also may be unable to sell its JV interests without the majority JV party's consent, even if it finds a willing buyer.

- While automatically asking for a long list of minority protection rights may be tempting, a minority JV party with extensive minority investor rights must be prepared to invest the time and attention required to properly discharge these rights over the life of the JV. A minority JV party may become frustrated over the volume or frequency of requests for its approval if it has too many consents rights. In addition, too many minority investor rights may unintentionally shift responsibility to the minority JV party or diffuse accountability away from the controlling JV party.

- In addition, a majority JV party understandably may be hesitant to relinquish too much control for several reasons, including:
  - The minority JV party possibly using minority investor rights to manipulate, or exert unfair leverage over, the JV or the majority JV party;
  - If the minority JV party has made a smaller initial contribution to the JV than the majority JV party (and, therefore, has less to lose if the JV fails), the minority JV party may be too willing to internalize risk; and
  - The potential, with respect to the JV's business, for (A) disruption caused by having to seek the minority JV party's approval or (B) paralysis if the parties cannot agree on a matter that requires unanimous approval.
    - A minority JV party may be more unlikely to sustain its focus on the JV—including timely consenting to matters requiring its approval—if it is a large strategic investor and the JV is a relatively small part of its overall business.

- Counsel to the minority JV party always should ensure that amendments to any minority investor protections require the minority JV party's consent.

- JV parties also should pay attention to how tax disputes are handled and whether they may incur tax liability for wrongdoing committed by any other JV party.

Observer Rights

- If the minority JV party does not have the right to appoint a board member, or if it wants to have one or more additional representatives attend board meetings, it may be able to negotiate observer rights, allowing it to designate one or more persons to attend board meetings in a non-voting capacity.

- Observers usually (i) are entitled to receive notices of, and documents regarding, board meetings to the same extent as board members and (ii) participate in board deliberations but without any voting rights.
Preemptive Rights

- Preemptive rights allow JV parties to subscribe for their pro rata share of any future equity (or securities convertible into, or exercisable or exchangeable for, equity) issued by the JV and, thus, to the extent exercised, prevent JV parties from being diluted by subsequent offerings.

  - A minority JV party that does not have a veto right over new issuances should seek to ensure that it has preemptive rights and, further, that the JV is required to provide sufficient notice prior to the offering’s closing, so that the minority JV party has sufficient time to decide whether to exercise its preemptive rights and, if so, to gather subscription funds.

  - A majority JV party understandably may not want the minority JV party to have a veto right over subsequent financings. Typical ways to permit funding but still protect the minority JV party are:

    - with respect to debt financing, to require debt funding either be (I) on arm’s-length terms and within certain agreed-upon limits or (II) approved by the minority JV party; and

    - with respect to equity offerings, preemptive rights.

- Certain issuances of equity securities should be excluded from preemptive rights, including securities issued (i) upon the exercise of any convertible security, (ii) to any JV employee under the JV’s equity incentive plan, (iii) as consideration for the acquisition of a third party, and (iv) as a dividend on outstanding securities or in connection with any stock split.

- To avoid unnecessary delays, there should only be a single subscription period, even if (i) multiple JV parties have preemptive rights and (ii) the balance of any offered securities for which other preemptive rights holders chose not to subscribe will be offered to the other subscribing preemptive rights holders, who have elected to subscribe for the entirety of their pro rata portions. These unsubscribed-for securities can be offered pro rata to such preemptive rights holders by allowing each such holder to specify, in its initial acceptance notice, up to what number of additional securities it wishes to subscribe (including a statement that it wishes to acquire the maximum amount of securities potentially allocable to it).

Affirmative Covenants

- Depending, in part, on the JV’s business and the minority JV party’s governance rights, a minority JV party may want to try to negotiate affirmative covenants that require certain actions to be taken by, or on behalf of, the JV, such as:

  - protecting the JV’s intellectual property;

  - complying, in all material respects, with applicable laws;

  - providing reasonable access to the JV’s books and records;

  - delivering annual budgets, business plans, and monthly, quarterly, and annual financial statements;

  - providing copies of reports, default notices, and other material correspondence with the JV’s lenders or regulators;

  - maintaining a minimum amount of certain types of insurance, like property and casualty insurance and directors and officers liability insurance; and
if the minority JV party does not have a veto right over the hiring and firing of the JV’s senior executives, advance notice of the hiring or firing of any senior executive officer.

A minority JV party’s information rights may be conditioned on it maintaining a minimum ownership threshold.

**Consent Rights**

While subject to negotiation and some differences based on the JV’s entity type and governance structure, the JV parties’ veto rights (whether exercised directly or through board representatives) usually are proportionate to the parties’ respective ownership interests. In JVs with a larger number of members, the major decisions subject to board or member approval sometimes are divided into categories requiring differing levels of approval, such as a category of material decisions requiring only majority approval and a separate category of more fundamental decisions requiring supermajority or unanimous approval.

A JV party’s veto rights may be conditioned on it maintaining a minimum ownership interest—e.g., 20%.

If the minority JV party lacks veto rights over equity issuances, this minimum ownership interest arguably should be adjusted equitably to prevent the minority JV party’s ownership interest from being diluted by subsequent issuances, particularly if the minority JV party also lacks preemptive rights.

In board-managed JVs, sometimes this approval is accomplished by requiring the approval of specified major decisions by the minority JV party’s board representative.

Matters over which a minority JV party (or, if there is more than one minority JV party, a majority or supermajority in interest of the minority JV parties) may have consent rights include:

- changing the JV’s name;
- admitting new JV members;
- redeeming JV equity interests;
- commencing an initial public offering;
- voluntarily dissolving or winding up the JV;
- entering into or modifying any related-party transaction;
- granting exclusive licenses of the JV’s intellectual property;
- making a capital call or requesting additional capital contributions;
- amending the JV’s scope or purpose or entering into a new line of business;
- incurring indebtedness above agreed-upon limits or granting liens on the JV’s assets;
- a sale of all, or substantially all, of the JV’s assets or entering into a material acquisition or divestiture;
- engaging or terminating the JV’s auditors, external accountants, outside legal counsel, or other key advisors;

- making any material tax election or changing any accounting policy or method (other than as required by GAAP);

- entering into JV agreement amendments that adversely affect the minority JV party or disproportionately benefit the majority JV party or its affiliates;

- hiring or firing, changing any compensation policies applicable to, or entering into any material agreement with respect to benefits, severance, employment, or consultancy with, the JV’s senior executives; or

- adopting or amending the JV’s business plan or annual budget or authorizing or incurring expenditures above budgeted amounts.

- To avoid consent rights during the JV’s early stages, the parties should consider adopting a detailed business plan at the time definitive documentation is executed. The business plan should (I) have operational and financial milestones and (II) methods for achieving these milestones, including requiring the JV parties to fund additional capital contributions and to provide employees to the venture (whether new hires or seconded or transferred employees). Any actions contemplated by the business plan should not be subject to a veto right.

- Projections included in the initial budget also provide an opportunity for the members to consider whether their expectations regarding the JV’s performance align.

- If concerns exist regarding the JV parties’ ability to agree on future budgets, the JV parties may want to provide for specific line items in the initial budget to be increased by certain percentages every year or, alternatively, to be modified according to specified formulas (in each case, in the event of unresolved disputes regarding these line items in future budgets).

- Consider limiting the number of matters JV parties must approve (i) to avoid delay and (ii) to reduce the chances of deadlock (discussed below). The parties may limit dispute resolution triggers to deadlock on significant issues, like approval of the venture’s budget or a change in the venture’s scope, particularly if the consequences of deadlock are severe (e.g., mandatory dissolution of the venture).

- Regardless of whether a minority JV party has any other investor protections, it should consider including, in the JV agreement, (i) a consent right over material changes to the JV’s purpose or business plan and (ii) a covenant that any arrangements (or amendments to any such arrangements) between the JV or any of its subsidiaries, on the one hand, and the controlling JV party or any of its affiliates, on the other hand, either be (A) entered into on arm’s-length terms or (B) subject to the minority JV party’s approval.

- The parties should be aware, however, that, if related-party agreements are permitted to be entered into on arm’s-length terms, disputes may arise over whether the terms are sufficiently favorable to the JV.

- A minority JV party also may want to require regular audits of any related-party transactions, such as if the majority JV party or any of its affiliates performs services for, supplies materials to, or manages the JV.

- Lastly, consider whether a material, uncured default by a JV party or its affiliate under a material related-party agreement should trigger a cross-default under the JV agreement, allowing the JV
or the other JV parties to exercise remedies against the defaulting JV party or its affiliate under both agreements.

- Venture documents should clearly indicate if the approval of one or more specific board members, equity holders, or both is required. Benefits of a JV party exercising its veto rights directly (rather than through board representatives) include:
  - allowing a JV party to keep track of significant board matters about which its board representative may be unable to notify it, whether because of the board representative’s fiduciary duties or confidentiality obligations or otherwise;
  - protecting against the possibility of (A) a board representative not voting consistent with the minority JV party’s wishes or (B) failures in notice, quorum, or other board-level procedural requirements undermining the board representative’s voting rights; and
  - unlike decisions made by board members subject to fiduciary duties (e.g., directors of corporations and managers of LLCs that have not eliminated fiduciary duties), a non-controlling JV party generally is free to exercise consent rights, without having to consider the best interests of the JV or other equity holders.

- However, if the minority JV party’s veto rights are exercised at the equity holder-level (rather than at the board-level), counsel to the minority JV party may need to consider whether—if the minority JV party’s governance rights are significant—the minority JV party could be deemed a controlling equity holder and, therefore, subject to fiduciary duties (depending on the JV’s entity type and the governing law of the JV’s jurisdiction of formation)
Exits and Terminations

Overview

- If the JV agreement does not provide a mechanism to resolve deadlock, the JV parties will be forced either to:
  - resolve the deadlock, however long it takes;
  - mutually agree to submit the matter causing the deadlock to mediation or arbitration;
  - litigate the matter causing the deadlock; or
  - seek judicial dissolution of the JV.

- Members of a Delaware LLC may petition the Delaware Court of Chancery for judicial dissolution of the LLC if “it is not reasonably practicable to carry on [its] business in conformity with [its] limited liability company agreement” (6 Del. C. § 18-802). If a JV’s purpose is narrowly drafted in the JV agreement, a court may be more willing to rule that it is not operating within its stated purpose and, as such, should be dissolved.

- However, a court-appointed custodian or court-ordered dissolution can lead to the loss of value and to a protracted legal dispute.

- If the JV agreement otherwise provides deadlock resolution mechanics, the JV parties may wish to waive their rights to petition for judicial dissolution, so that no JV party can circumvent the agreed-upon procedures.

- The very existence of dispute resolution mechanics can incentivize management to resolve the matter themselves. It does, however, inevitably offer scope for manipulation by a party, which is why some prefer to omit such clauses and leave the matter to negotiation.

- Well-drafted exit and termination provisions should address:
  - survival of non-competition and non-solicitation obligations;
  - the withdrawing JV party’s (A) ability to use or disclose the JV’s confidential information and (B) obligation to return or destroy such confidential information;
  - the resolution of shared assets, including jointly-developed assets, assets leased or licensed to the JV by the withdrawing JV party, and a JV name or trademark related to the withdrawing JV party’s name or trademarks; and
  - the consequences of withdrawal on arrangements between the JV and any of its subsidiaries, on the one hand, and the withdrawing JV party or any of its affiliates, on the other hand, including:
    - IP licenses,
    - advisory or management services agreements,
    - guarantees of JV indebtedness or other obligations, and
commercial contracts, such as distribution agreements and service / support agreements.

Lastly, when designing and negotiating exit provisions, consider the potential legal, regulatory, accounting, and contractual consequences of changing either the JV parties or their respective ownership percentages.

**Deadlock**

Deadlock typically is defined as the inability of the JV parties to reach the supermajority or unanimous approval needed to authorize a particular action.

Methods for resolving deadlocks include:

- requiring the JV parties to negotiate for a set period;
- allowing an independent member of the JV’s governing body, if any, to break the deadlock;
- escalating the issue to specified high-level officers of each JV party;
  - The threat of enforcing an escalation provision often is enough to encourage JV parties to agree.
  - Key issues to consider when drafting and negotiating escalation provisions include (I) the types of disputes subject to escalation, (II) to whom matters will be escalated, and (III) the specified period of time during which officers will be required to attempt to resolve the deadlock.
- mediation or arbitration;
  - In rare cases, mediation or arbitration may be binding, and the mediator or arbitrator may resolve the deadlock by deciding the matter as an independent expert or by siding with a JV party as a neutral tie-breaker.
  - However, mediation and arbitration most often are used to assist in resolving deadlock, because (I) complex business decisions most often result in deadlock and (II) mediation and arbitration are better suited at resolving factual matters.
  - Key issues to consider when drafting and negotiating mediation or arbitration provisions include (I) the types of disputes subject to mediation or arbitration, (II) whether there should be a single mediator / arbitrator or panel of mediators / arbitrators, and (III) whether the mediator(s) / arbitrator(s) should have any specific credentials.
- buy-sell provisions providing each JV party with the right to offer to buy the other JV party’s interests, or sell its interests to the other JV party, at an agreed price or based on an agreed pricing mechanism set forth in the JV agreement; and
- finally, if deadlock cannot be resolved pursuant to any of the above-mentioned methods, dissolution of the JV.

**Default (including Insolvency and Change of Control)**

Because a JV typically relies on contributions or other support from the JV parties, a default by a JV party or its affiliates in its obligations to the JV can have significant adverse consequences on the JV...
and other JV parties. Exit provisions may vary in the event of a default or change of control because one party is at fault.

- Common events of default include:
  - the insolvency of a party;
  - a change in control of a party (which arguably should be inapplicable to publicly traded JV parties); and
  - a party’s material, uncured breach of the JV agreement or other material arrangement between the JV or any of its subsidiaries, on the one hand, and a JV party or any of its affiliates, on the other hand.

- The parties may prefer to limit trigger events to uncured breaches of specific provisions to minimize the potential for disputes over whether a breach is material and to avoid applying harsh consequences to lesser defaults.

- Because the JV parties’ identities (and what each contributes to the JV) are critical to the JV’s success, a change of control of a party often is treated like a default. A party may be reluctant to treat any change of control as a default, as the identity of the new indirect JV party may not adversely affect the JV and, as such, creating optional rights in favor of the other JV parties may result in a windfall.

- A minority JV party may wish to seek the right to assert a claim, on the JV’s behalf, if the majority JV party breaches its obligations under the JV Agreement. In turn, the majority JV party, to disincentivize frivolous claims, may wish to require the member asserting an unsuccessful claim to reimburse any amounts (i) advanced to it in asserting the claim and (ii) incurred by the JV or majority JV party in connection with the unsuccessful claim.

- Because a claim for breach of contract against the JV may be of questionable value (especially because a non-breaching JV party owns a portion of the JV and, consequently, would be responsible for its pro rata share of any monetary judgment against the JV), JV parties may want to include specific contractual remedies to address defaults. The appropriate remedies vary based on the type of default but could include:
  - with respect to the non-defaulting JV party, an increase in any dividend accruing on invested capital, reduction in the conversion price of any convertible JV securities, or other enhanced economic rights;
  - with respect to a default in ROFR- or ROFO-related purchasing obligations, (A) the loss as liquidated damages of a deposit, if any, previously delivered to the transferring JV party or (B) the loss of ROFR or ROFO rights with respect to future transfers;
  - an increase in the non-defaulting JV party’s board representation or voting or management rights or a loss or reduction of the defaulting JV party’s board representation or voting or management rights (although the defaulting JV party may regain these rights once the default is cured); and
  - the triggering of a call right, put right, or buy-sell provision or of the mandatory dissolution of the JV.
Mandatory Dissolution

- One potential exit mechanism, whether because of deadlock or otherwise, is to return to the JV parties the assets each contributed to the venture. While this can be an appealing option early in a JV, its practical use may be limited once the JV has been operating for some time or its assets are commingled in a manner that makes returning contributed assets to the individual parties impractical.

- Another possibility is to liquidate the JV’s assets and distribute the proceeds to the parties following satisfaction of creditors’ claims, though this may lead to a loss of value. However, the JV parties may believe that, if deadlock exists, the business should be sold, either as a going concern or otherwise, rather than going through a buy-sell procedure, with the individuals managing the dissolution being tasked with maximizing the liquidation proceeds.
  - Either a specified party, board member, or officer, or a committee of specified individuals, may manage the dissolution.

- More often, mandatory dissolution procedures are used as backup if buy-sell procedures do not result in either party buying out the other, but with deadlock continuing as a threat to the JV’s prospects.
  - Alternatively, in the event of default, the non-defaulting party may prefer dissolution and may want the right to compel mandatory dissolution in the first instance.

- Key issues to consider when drafting and negotiating mandatory dissolution provisions include:
  - Who controls the process?
  - Are there circumstances in which the JV parties should not be allowed to participate as potential purchasers?
  - What standards should apply to the controlling party’s conduct? For example, should the controlling party use commercially reasonable efforts to maximize proceeds? How widely (and for how long) does the business need to be marketed? Should the controlling party retain an investment banker to conduct an auction of the business and, if yes, to recommend which bid is superior?

- Liquidation proceeds will be used to pay dissolution costs, satisfy debts owed to third party creditors then debts owed to the JV parties, and, thereafter, the remaining proceeds, if any, will be distributed to the JV parties in accordance with their respective equity percentages or capital accounts, as applicable.

Put Rights

- A put right gives a JV party the right to sell its interests to the JV or another JV party, upon the occurrence of specified events, for an agreed price or based on an agreed pricing mechanism. For example, a JV party may have a right to require the JV or other JV party to purchase its interests:
  - to achieve liquidity if its JV interests still are outstanding after a specified date;
  - if the JV achieves, or fails to achieve, a certain goal or milestone in its business plan (whether financial or otherwise);
  - in the event of a material, uncured failure of the JV or another JV party to perform its obligation under the JV agreement (although, as mentioned above, trigger events may be limited to uncured breaches of specific provisions); or
in the event of a change of control of another JV party—e.g., a minority JV party’s put right may be triggered by a change in control of the managing JV party—however, as mentioned above, change of control provisions may be inappropriate for publicly traded JV parties.

**Call Rights**

- A call right gives the JV or another JV party the right to force a JV party to sell its interests to the JV or other JV party, as applicable, upon the occurrence of specified events, for an agreed price or based on an agreed pricing mechanism.

  - These events may be similar to the triggering events for the exercise of a put right—e.g., if a minority JV party materially breaches its obligations under the JV agreement, a controlling JV party may have the right to acquire the minority JV party’s interests.

- A put right may be included in a JV agreement without a reciprocal call right, but a call right often is negotiated along with, or in exchange for, a put right.

**Buy-Sell Provisions**

- **Overview**

  - A buy-sell provision often is used in the event of deadlock and, with certain modifications, in the event of a change of control of, or material, uncured breach of the JV agreement by, the other JV party. A buy-sell provision results in one JV party buying out the other at a price typically based on the value of the JV or its assets, and therefore, when the buy-sell provision is invoked, it ends deadlock by removing a JV party from the venture.

  - In non-default situations, the buy-sell provision can be invoked by either party, usually only after other methods of resolving deadlock have proven unsuccessful.

  - Many times, the buy-sell provision cannot be invoked during an initial specified period, such as the first two years of the JV’s life, to commit the parties to the JV for some minimum period before any exit procedures may be exercised. Agreement on the initial business plans and budgets arguably should allow the parties to work through disagreements over other items during the initial period.

  - In a default situation, the non-breaching party may invoke the buy-sell provision if the default has not been remedied following expiration of any applicable cure period. The price will need to be set by a valuation mechanism.

- **Russian Roulette**

  - Although the mechanics of a buy-sell provision can vary, in a typical formulation, one JV party notifies the other party that it wishes either to buy the other party’s interests or sell its interests at a stated price, and the offer recipient then elects either to buy the initiating JV party’s interests, or sell its interests, at that price.

  - In some cases, if the buying JV party defaults on the purchase, the selling JV party may have the option to pursue remedies or become the purchaser at a discount, such as 90% of the price the defaulting JV party would have paid.

  - As discussed further below, this may be interpreted as an election of remedies and as liquidated damages.
• In theory, because neither JV party, at the outset, knows which JV party will buy and which will sell, a Russian Roulette buy-sell provision should ensure that the initiating JV party proposes a fair and reasonable valuation. A low valuation may incentivize the non-initiating JV party to buy, while too high a valuation may incentivize the non-initiating JV party to sell.

• However, while a Russian Roulette buy-sell provision is a common dispute resolution procedure in a two-party JV, venturers should be aware that, if the parties have disparate financial resources, a Russian Roulette buy-sell provision can unfairly advantage a JV party with superior resources.

• For example, the initiating JV party may fix the price at which the JV interests must be bought or sold below market value if it knows that the other JV party does not have sufficient financial resources to elect the buy option, even at a below market price. This results in the non-initiating JV party being forced out at an artificially depressed price.

• The non-initiating JV party may be protected if it may tender a promissory note for the other party’s JV interests. However, this raises additional issues the parties will need to resolve, including issues relating to interest rates and credit worthiness.

• A JV party with less liquidity also may be able to negotiate the right to extend the period during which it may elect to exercise its buy-sell right or to close the transaction. This affords the non-initiating party additional time to procure the financing needed to buy out the other JV party.

• Further, a JV party with less liquidity may be protected if it can assign its purchase rights to an affiliate or third party with sufficient liquidity.
• **Texas Shootout**
  
  In a Texas Shootout, one party notifies the other that it is commencing an appraisal process, which will establish a floor price. Each party notifies the other whether it wishes to buy or sell at the appraised value. If one party wishes to sell and the other wishes to buy, the parties proceed to closing. If both parties wish to buy at the appraised value, an auction process is commenced, often with minimum incremental bids being required to top the other party’s immediately preceding bid. The party that is willing to pay the most for the JV ends up as the buyer.

  - In some cases, if the buying JV party defaults on the purchase, the selling JV party may have the option to pursue remedies or become the purchaser at a discount, such as 90% of the price the defaulting JV party would have paid.

  - If both parties wish to sell, they need to continue to work out the dispute. If neither party is willing to pay the determined price to break the deadlock, the deadlock arguably is not yet a material threat to the JV’s health.

  - However, this approach can be coupled with an additional clause providing that, if the same dispute is the subject of a second deadlock within 12 months and both parties again wish to sell, the parties will be required to sell the business in a manner designed to maximize the proceeds.

  - A Texas Shootout buy-sell provision may be preferable (even when there is not a disparity in the parties’ financial resources) because it sets a floor price in a fair manner and allows for more deliberation.

**Other Buy-Sell Structures**

  - Alternative Structure 1: Each JV party sends a sealed bid to an independent third party setting out the minimum price at which it would be willing to sell its JV interests. The JV party with the higher bid (and who, therefore, values the JV the most) buys out the other JV party’s interests at the price indicated in the lower bid.

  - A JV party that undervalues its JV interests may leave money on the table by being forced to sell at that price, while a JV party that overvalues its interests (in the hopes of receiving that price) may end up being forced to buy the other JV parties’ interests.
• Alternative Structure 2: Each JV party sends a sealed bid to an independent third party setting out the maximum price at which it would be willing to buy the other JV party's interests. The JV party with the highest bid wins and must buy the other JV party's interests at the higher bid price.

Valuation Considerations

• The parties may elect to value JV interests, or the JV’s assets, in a variety of ways, including:
  ▪ at a fixed price set out in the JV agreement;
  ▪ based on a set formula (e.g., a minimum return on invested capital or, if the JV is engaged in an operating business, an agreed multiple of its trailing 12-month EBITDA);
  ▪ If a formula is used, consider attaching a sample calculation to the JV agreement.
  ▪ by an appraisal of the JV’s fair market value by an investment bank or other valuation expert, with fair market value being determined in accordance with specified parameters (e.g., (A) taking into account the expected amount of distributions to be made prior to the valuation, (B) assuming the making of any capital contributions required to be funded prior to the valuation, and (C) disregarding any (I) minority discount, (II) compulsion to sell, and (III) impact of an immediate sale); or
  ▪ based on a market check.

• Additional considerations include (i) the deemed date of the sale for valuation purposes (e.g., the date of service of a termination notice), which may have a significant impact on value if the process is prolonged; (ii) how investment banking or valuation expert fees will be borne (e.g., equally, in proportion to JV interests, or solely by the party calling for the appointment of a valuation expert); and (iii) whether the valuation should reflect any imputed costs.
  ▪ To avoid overvaluing the exiting JV party’s interests, the valuation arguably should reflect certain imputed costs—e.g., advisors’ fees, brokerage commissions, and transfer taxes (if applicable). The non-exiting JV party may ultimately incur these costs in a sale of the JV or its assets, so requiring the exiting JV party to internalize its pro rata share of these costs arguably is fair, even if these costs will not be incurred in the relevant transaction.

• In the context of a default, JV agreements sometimes permit the non-defaulting party to acquire the defaulting party’s interests at a discount—e.g., 90% of appraised value.
  ▪ There is a risk, however, that the discount could be interpreted as liquidated damages and as an election of remedies, regardless of the parties’ intent, unless the provision is carefully drafted.
  ▪ Even if the parties intend for the discount to constitute liquidated damages, predicting the damages resulting from a future default is extremely difficult, and other remedies—such as the ability to choose to buy, at fair market value, with a note payable over several years—while retaining all rights to remedies for the underlying default, may be preferable to speculating that the discount will be substantially equivalent to the damages resulting from the future default.
Tax Considerations

- If the purchase price in any buy-sell mechanic will be paid over time using a promissory note or other installment payments, consider tax treatment to defer tax over time.

- If the principal JV party is a natural person, consider triggering buy-sell mechanic upon the principal’s death, with the purchase price being funded with the proceeds of a life insurance policy paid for by the JV. Careful attention to structuring of such a transaction is necessary to maintain tax benefits.