<u>JOINT VENTURES: *JE NE SAIS QUOI*</u>

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In everyday conversations, including conversations among lawyers and sophisticated businesspersons, the term "joint venture"(<u>JV</u>) is typically used as if its meaning is self-evident. This can lead to miscommunications and misunderstandings because the term can be used to describe a wide array of arrangements between two or more parties. The differences among those various types of arrangements, all of which might constitute a JV, can have a significant business and legal impact on the co-venturers. A multiplicity of arrangements between or among parties, which can arise in myriad ways for a broad spectrum of reasons, can constitute a joint venture. For example, joint ventures can be created as an alternative to mergers and acquisitions (M&A) transactions or in connection with them, and they can be structured as contractual joint ventures and joint venture companies. Notwithstanding the diversity of joint ventures, this article will venture an inclusive definition of a "joint venture," will highlight some of the most popular reasons for creating joint ventures, and will encourage entrepreneurs and deal professionals to provide some specificity regarding the function of a particular joint venture before assuming that a counterparty or respondent understands exactly what is meant by "joint venture." Furthermore, because the flexibility of the JV structure can be employed in a wide variety of scenarios with different functions and objectives, it is critically important for the businesspersons proposing and negotiating the deal to ensure that their lawyers are intimately familiar with the legal nuances and market norms that apply to the intended functions and objectives of their particular joint venture. So long as the lawyers satisfy that threshold requirement for the particular JV contemplated, finding a lawyer or team of lawyers who have the requisite expertise and experience across numerous types of joint venture structures, with their wider array of potentially applicable experiences and precedent, can be helpful in fashioning creative solutions to deal-specific issues.

What is Unclear About the Term "Joint Venture"?

Many people do not appreciate the multiplicity of arrangements between or among parties that might constitute a joint venture, the manifold ways that such arrangements can arise, and the broad spectrum of rationales for agreeing to enter into such arrangements. For example, each of the following is true:

- JVs may be structured as purely contractual arrangements, or they may be implemented through one or more separate legal entities.
- JVs may involve two parties or many more.
- JVs may be for a limited period of time or perpetual.
- JVs may be legal and/or tax partnerships or they might take other forms.
- JVs may be created as an alternative to M&A transactions or in connection with them.
- JVs can involve the co-venturers' contributions or commitments of cash, intellectual property, personnel, and a wide variety of other goods or services.

Because of the variety of JVs that can be created, gleaning a uniform set of characteristics is deceptively tricky.

Defining "Joint Ventures"

Joint ventures are arrangements in which separate parties can unite in some manner to achieve a common business objective whereby they will agree to share certain inputs and outputs while maintaining legal individuality. Fundamentally, JVs are about combining co-venturers' assets and capabilities in unique ways, while simultaneously maintaining those parties' distinct identities, in order to unlock opportunities and value that none of the individual parties could access as efficiently alone. One of the core tenets of creating a JV is that each co-venturer, or potentially each group of similarly situated co-venturers, has some level of meaningful input over a meaningful aspect, or potentially a wide array of aspects, of the JV's operation or strategy. Another core tenet of creating a JV is that, when done correctly, the sum should be more than the whole of its parts; in other words, uncovering and unleashing synergies is the name of the game, and each party to the JV should shoulder some of the associated risk in order to benefit from a portion of the reward.

Joint ventures can be divided into two broad categories: Joint ventures that are implemented through mere contractual arrangements and joint ventures that are implemented through one or more distinct legal entities created for specifically for the purpose of facilitating the desired collaboration. We'll refer to the former as "Contractual JVs" and the latter as "JV Companies," which is the common parlance for those "in the know."

Contractual JVs are sometimes referred to as "strategic alliances" and JV Companies are sometimes referred to, somewhat confusingly, as "joint ventures." In the United States, a "joint venture" is not a specific or distinct legal entity; instead, JV Companies are typically formed as state law limited liability companies, limited partnerships (or other types of limited liability partnerships, depending on the circumstances), or corporations. The state-law entity type will affect the federal income tax classification of the applicable entity, but the choice of entity is not outcome determinative in this regard. For example, a JV limited liability company (LLC) can be taxed as a partnership, an S corporation, or a C corporation for federal income tax purposes. Examination of the pros and cons of various tax elections is beyond the scope of this article, and tax experts have expounded those in countless other articles. Similarly, I will defer an analysis of the pros and cons of Contractual JVs vs. JV Companies to a later article and will instead focus simply on describing the various types of joint ventures that parties can create.

Functions of Joint Ventures

Function influences form in joint ventures, and there are many different reasons why parties may desire to enter into a joint venture. The following are some of the more common reasons why parties enter into joint ventures. In each instance, the nature of the relationships and the unique characteristics of the parties involved create a multiplicity of distinct issues concerning, among other things, financial and economic rights, management and control rights, and rights concerning the assets or services contributed to and produced by the joint venture. It is, therefore, essential for successful joint venture's structure and documentation to be tailored to address those particular issues and interparty dynamics. Reliance upon "standard" or "one-size-fits-all" documents without thoughtful customization is likely to jeopardize the ultimate success of the joint venture or to result in unanticipated, and often significant, consequences for the co-venturers.

Pooling of Resources (a/k/a Strategic Partnerships). These arrangements are probably what springs to mind for most people when they think of "joint ventures." They arise when two or more parties with distinct resources pool those resources for intended synergistic effect. Examples of these types of strategic partnerships abound. In an effort to avoid writing a catalog of pertinent examples, it may be helpful to note that an examination of joint ventures founded upon the pooling of resources lends itself to three subclassifications for prospective co-venturers to consider: (1) fungible-asset-pooling joint ventures, which are designed to increase the utilization of co-venturers' existing interchangeable or virtually indistinguishable assets, (2) complimentary-asset-pooling jointing ventures, which combine similar but non-identical assets with complimentary uses for synergistic effect, and (3) asymmetric-asset-pooling jointing ventures, which creatively combine assets with no apparent or complimentary relationship for synergistic effect. Among other issues germane to such co-ventures, co-venturers should recognize and address the competitive and anticompetitive tensions that vary along this spectrum of subclassifications.

Control / Non-Control Investments (i.e., Financial Partnerships). These types of arrangements arise with great frequency and result from the sale of less than all of the equity ownership of a JV Company. The sale, whether of a controlling stake or a non-controlling stake in the JV Company, can be the result of a direct investment in the JV Company in exchange for an issuance of equity by the JV Company, or the sale can be a secondary transaction whereby the owner of equity in the JV Company sells a portion of that equity to the buyer resulting in a joint-venture relationship. The transition of a company from one owner to multiple owners introduces significant complexity into the business and legal arrangements that should be addressed.

Although controlling interest acquisitions are typically associated with majority ownership of financial or economic rights and non-controlling interest acquisitions are typically associated with minority ownership of financial or economic rights, that is not necessarily the case. In certain types of JV Companies, such as limited liability companies, equity ownership can be divorced from "control" or decision-making authority. As is often the case, "control" may be limited to certain key events for one co-venturer or group of co-venturers. This may result in joint control, which rarely exists in well-constructed JV Companies because of its propensity to produce deadlocks (if both or multiple parties must act in concert), inadvertent inaction (if both parties are vested with independent authority to act and each believes the other is undertaking the action), and conflicting actions (if both parties are vested with independent authority to act and undertake uncoordinated actions). Instead, well-constructed JV Companies typically provide for some degree of shared control in connection with specific events and provide for specific steps that must be undertaken in those circumstances while reserving unilateral control for a designated party in other circumstances.

For example, one of the many distinguishing features between the typical private equity (PE) firm and the typical venture capital (VC) firm is that the former typically take control positions, often with majority equity ownership, in a relatively limited number of portfolio companies whereas the latter tend to take non-control positions, often with minority equity ownership (at least initially), in a relatively large number of portfolio companies. This is a generalization, and there are certainly differences among PE firms and VC firms and their strategies and styles. There is also a fair amount of convergence blurring of more historically clear dividing lines between these two groups of financial investors. Additionally, VC firms usually do not expose themselves to undue risk through their non-control positions and, accordingly, negotiate various contractual protections to limit the risk associated with their non-control investments.

Pairing Expertise with Capital to Share Profits (Management Expertise or "Sweat Equity" + Capital). This is another common form of joint venture, which is essentially a version of a "financial partnership" where the day-to-day management is divorced from, and typically inversely related to, the contributions of assets to the joint venture. Often one co-venturer or a specific group of co-venturers, whom I'll refer to as the "investors," agree to contribute capital to the joint venture in reliance upon another co-venturer or another group of co-venturers, whom I'll refer to as the "management," agreement to utilize that money in a specific way to generate a return on investment. A distinguishing characteristic of these joint ventures is that the financial structure involves, to some degree, a "flip" of the financial structure such that the investors are entitled to the lion's share of the free cash flow distributable by the joint venture until the investors have receive a return of their capital invested plus some agreed hurdle rate of return and, thereafter, the management receives a share of distributions that is disproportionately larger than the capital invested by the management in the joint venture. That right to a disproportionate share of the distributions upon satisfaction of the performance hurdle is often referred to as a "carried interest."

These types of joint ventures appear in many different industries and can involve scenarios where the details of the contemplated project are known by the investors before they invest (Line-of-Sight JVs), but they are also the structure of choice for scenarios where money is raised from investors on the conviction that the manager will earn a certain return on their investment utilizing some predefined strategy (often referred to as "blind pool" investments). Real estate joint ventures are often, but certainly not exclusively, Line-of-Sight JVs and can arise in various scenarios, including land contribution (*e.g.*, a landowner and a developer), construction management (*e.g.*, investor and developer), or capital constraints (*e.g.*, a company with all the resources to complete a particular project other than sufficient capital or credit). PE firms who specialize in upstream oil and gas investments commonly back management teams by entering into joint venture companies where the PE firm will commit the vast majority of the capital (sometimes nearly all of the capital) and the management team will contribute a strategy and the expertise to successfully execute that strategy to the mutual benefit of all involved such that the management team earns into some form of carried interest after the PE firm receives a return of its capital plus the achievement of some agreed hurdle rate of return. Various types of investment funds—for example, blind-pool funds (*i.e.*, PE funds, VC funds, and real estate funds), pledge funds, and search funds—all incorporate similar structures where financial investors rely on the specific expertise of an individual manager or a management team to invest capital and generate a return for the investors in an arrangement whereby the manager earns a carried interest after the investors receive requisite distributions.

Performance Incentives and Alignment of Interests. Equity grants, or equity purchase rights, as performance incentives to key service providers (KSPs) do not necessarily create a "joint venture" as most people would define it, but the balance of power between equity owners pre-grant and post-grant is a key factor in determining whether the label fits. For example, in an entity with widely dispersed ownership where KSPs own, in the aggregate, a small share of the business—for example, 10%—few persons would, without more, label the arrangement a joint venture, at least vis-à-vis the investors and the KSPs.

Some joint ventures, however, are formed for the sole or primary purpose of aligning the interests of a KSP, or multiple KSPs, with those of the lead investor or group of investors. Parties can create these types of joint ventures via direct grants of equity to KSPs (*e.g.*, the issuance of profits interests), enabling KSPs to purchase capital interests (*e.g.*, direct equity sales, including sales pursuant to purchase rights exercised by the KSP, often funded with capital borrowed from other co-venturers), and rollover equity in connection with the KSP's sale of its business to new majority owners. In those instances, the investor relinquishes some portion of its ownership so that the KSP—*i.e.*, someone who has an outsized influence on that underlying business through their provision of services to it—can participate in that business as an owner in addition to as a service provider. The delivery of that ownership interest in the business to the service provider can take place in a single JV Company (the "direct-ownership approach") or through the creation of a multi-layered ownership structure (the "indirect-ownership approach"), whereby the service provider might, for example, obtain an equity interest in a newly formed holding company that is created for the dual purpose of owning the underlying business through a separate legal entity (*i.e.*, the operating company) and issuing equity to KSPs to the operating company. In the direct-ownership approach, the service provider renders services directly to the entity in which it owns equity. In contrast, in an indirect-ownership approach, or multi-layered structure, the service provider typically renders services to a subsidiary of the entity in which the service provider owns equity; accordingly, in the indirect-approach "performance/alignment" joint venture structure, the "joint venture" is essentially a collection of interrelated, interdependent entities. Each structure has its pros and cons, including securities law and tax consequences to be considered and weighed.[1]

The means by which the business owner delivers equity to the KSP, thereby creating a co-ownership arrangement, can vary greatly, although certain approaches are more common than others:

- The type of legal entity owned and federal income status of that entity exert significant influence on the structural choices available to the business owner and KSP. For example, a corporation taxed as a C corporation might issue stock options to a KSP, whereas an LLC taxed as a partnership might issue profits interests to the KSP. But whereas such an LLC could be structured to enable the issuance of equity options to the KSP, a corporation taxed as a C corporation is unable issue profits interests to that KSP.

- Another element for consideration by the business owner who desires to issue equity performance incentives to a KSP is the degree of "skin in the game" required of the KSP. In these scenarios, the KSP would be required to purchase capital interest in the joint venture, often in addition to other incentive interests, such as, *e.g.*, stock grants or profits interest issuances. Typically, the goal on the non-KSP co-venturers—*i.e.*, the financial investors—is to create a significant financial burden for the KSP such that the KSP would feel some degree of

[1] The exploration and analysis of those issues could fill many more articles and, thus, is beyond the scope of this article.

> financial pain if the joint venture is unsuccessful, but not a crushing burden that would bankrupt the KSP or would unbalance risk and reward from the KSP's perspective. Financial investors often achieve such an arrangement by loaning to the KSP some or all of the capital needed by the KSP to make the KSP's capital investment.

Often, but not universally, the KSP who is granted or otherwise purchases equity in the business to create the "performance/alignment" joint venture exercises relatively little control, and sometimes no control, over the business pursuant to the KSP's equity rights. Instead, the KSP exercises outsized influence over the business through the services the KSP provides to the business, and that outsized influence is often precisely *why* the KSP is awarded equity in the business. In this way, a well-constructed "performance" joint venture creates a degree of balance or even beneficial tension between or among the co-venturers so that each is, to some degree, reliant upon the other(s) in order for the joint venture to succeed, but the balance is typically one where the financial investors wield equity-based rights and the KSPs wield outsized influence over the direction and success of the business and its performance. Such an arrangement doesn't mean that the co-venturers are irrevocably wed to the joint venture, but a properly fashioned arrangement enables co-venturers to exit, readjust, substitute co-venturers, or otherwise disband in an organized manner that usually incorporates some degree of effort or necessary pain of some variety.

Cost/Risk Diversification. Sharing costs or risks with co-venturers, and thereby reducing the costs and risks shouldered by any one individual in the business endeavor, is another key reason for forming a joint venture. In many industries and sectors, the capital or other resources—including people and time—required by a business to achieve minimum efficient scale is cost-prohibitive for certain individual "would-be" participants. In other instances, direct, foreseeable costs many not be an issue, but indirect and unforeseeable costs and other risks might render an otherwise attractive project unappealing. When those costs and risks can be shared among co-venturers, capital outlays and other upfront costs may become bearable and large but uncertain upside benefits may outweigh the related risks.

Cost/risk diversification can be achieved at essentially any time during the life of a joint venture. In some instances, joint venturers seek this type of diversification at the outset. For example, family offices and PE funds might enter into consortium acquisitions or "club deals" in connection with their initial investments in a company. Owners of business might also seek new financing from outside sources who might be willing to provide that financing in exchange for equity ownership and certain control or "blocking rights" over the joint venture's business, operations, capital structure, and ownership. Finally, owners might diversify and de-risk their positions in a business by selling most of their equity ownership but retaining a toe-hold position with certain protective rights (*e.g.*, tag-along or co-sale rights, blocking rights on a modest list of enumerated "major decisions," minority board position, etc.) as tail-performance insurance.

Workarounds for Legal Restrictions on Ownership/Operation. Joint ventures are often an elegant solution for legal restrictions on ownership or operations that can arise in a variety of scenarios. Domestically, common examples include joint ventures—often part of a multi-entity ownership structure bridged with complex services contracts—that are designed to address "Corporate Practice of Medicine" or "Corporate Practice of Law" restrictions whereby applicable laws prohibit ownership of a medical or legal practice by persons not licensed to practice medicine or law, respectively. Those restrictions are typically premised on the belief that physicians must be able to exercise their professional medical judgment for the benefit of their patients without extraneous influences from non-physicians and that lawyers must be able to exercise their professional legal judgment for the benefit of their clients without extraneous influences from non-lawyers, respectively. Internationally, many jurisdictions impose restrictions on the ownership of business enterprises by foreigners. Joint ventures created to address foreign-ownership restrictions remain subject to potential legal or regulatory changes, which may require or enable a rebalancing or the parties' ownership or other rights from time to time, so co-venturers in such arrangements should endeavor to create mechanisms in their contractual or governance relationships that provide for related flexibility in a manner that minimizes or avoids the need to renegotiate terms.

Employing a joint venture as a solution to ownership restrictions imposed by law can involve the creation of a JV Company with a meticulously crafted ownership and control structure, sometimes utilizing multiple classes of equity and multiple-tiers of ownership, such that a certain percentage of ownership and a certain degree of control remain with the co-venturer who must legally have that ownership and exercise that control. In other instances, the joint venture might be structured as a Contractual JV composed of one or more contracts with various enabling and restrictive covenants and often featuring offsetting obligations that are finely balanced and designed to facilitate the achievement of a shared objective.

Tread Carefully

The sharing of risk and reward coupled with the ongoing nature of the joint-venture relationship can offer participants numerous benefits and competitive advantages, but the creation of a joint venture, particularly between or among two or more distinct businesses, is among the most complex transactions in which a business can choose to engage. Parties who contemplate establishing a joint venture must navigate issues regarding both the pooling and separation of assets (including funding arrangements and issues regarding the use of intellectual property, real property, and other assets), control dynamics and governance issues, non-competition issues and other restrictive covenants, revenue sharing, tax liability issues, and exit dynamics. Accordingly, businesses and individuals who are considering a joint venture should retain sophisticated advisors with extensive experience constructing, operating, and dissolving joint ventures in order to maximize their odds of success and to minimize their exposure to potentially disastrous pitfalls. Depending on the nature of the business conducted by the joint venture, regulatory experts and their guidance might be critical to the joint venture's success, as well. Joint ventures are subject to certain risks that are unique to their ownership structure in addition to the numerous risks that all businesses face, but parties' utilization of advisors with only passing familiarity in the nuances of joint venture transactions is, unfortunately, a commonly endured but easily avoidable risk.