

Planning for a Successful Joint Venture

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1. Introduction

Introduction

- Our goals today are to:
 - Discuss why negotiating joint ventures can be harder than M&A transactions and why term sheets are more useful than in M&A deals
 - Focus on some of the issues most likely to cause friction in a joint venture negotiation:
 - Scope of the venture
 - Governance issues
 - Resolving deadlocks
 - Exit provisions
 - Issues arising when the venture and partners share assets



2. Getting Started

Getting Started – Why is it so hard?

Negotiating and drafting joint ventures is very challenging:

- Often more difficult than negotiating and drafting an acquisition agreement.
- Joint ventures contemplate ongoing business relationships, not a one-time transaction
 - Relationship must be durable and flexible to allow for change as business plans, market conditions and other factors evolve
- No such thing as a standard “off-the-shelf” deal
- Few “market” terms
- Lots of tricky issues that can be resolved in many different ways depending on partners’ goals, leverage, etc.
- Partners have to predict the future, e.g., the venture’s future funding needs
- Challenges are getting harder, not easier

Getting Started – Term Sheets & Letters of Intent

Given the complexity in drafting and negotiating joint ventures, partners should strongly consider starting with a term sheet or letter of intent.

- Advantages of term sheets and LOIs include:
 - Helps impose order on a complex discussion
 - Focuses business people on critical choices
 - Confirm agreements on fundamental issues
 - Select issues to focus on initially and defer thornier issues until later
 - Gives lawyers better guidance for drafting agreements
 - Working together to outline the venture may promote success
 - Partners feel committed to the project and one another sooner
 - May be able to file HSR notice using term sheet / LOI

Getting Started – Joint Venture Formation Agreements

Joint venture formation agreements are another useful tool.

- Becoming more common
- Can be used in a variety of ways:
 - Develop a plan for the joint venture with more detail than a term sheet or LOI
 - Roadmap for formation of the venture including timelines for negotiating deal agreements, obtaining required consents, contributing assets and closing
 - List conditions to closing and describe closing mechanics
 - Can keep certain provisions separate from the governance documents, e.g., representations & warranties and indemnification



3. Defining the Scope of the Joint Venture

Defining the Scope of the Joint Venture

Typically heavily negotiated.

- Defines the nature of the venture's business.
- May restrict types of business the venture may conduct.
- May limit geographic areas in which the venture operates.

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

- Non-competition provisions.
- Application of the corporate opportunity doctrine.

Changes to the scope often require higher level of board and/or partner approval.

- Each partner may have the right to veto proposed changes to the scope of the joint venture.



4. Typical Governance Structures

Typical Governance Structures – Common Approaches and Issues

50/50 Joint Venture

- Management is responsible for day-to-day operations
- Governing board oversees management
 - Each partner appoints the same number of members to board (or has equal voting rights)
 - Members are removed and replaced by the partner that appointed them
- Specified actions require board approval, including board member(s) appointed by each partner
- Partners have separate voting rights as equity holders
 - *E.g.*, capital calls beyond a cap or fundamental actions such as changes in the venture's scope must be approved by both partners
- One or more deadlock resolution mechanisms, such as buy-sell mechanism

Typical Governance Structures – Common Approaches and Issues

Venture with a Majority Partner and one or more Minority Partners

- Management is responsible for day-to-day operations
- Governing board oversees management
 - Majority partner appoints a majority of the board
 - Members are removed & replaced by the partner that appointed them
- Specified actions require board approval; shorter list of actions may require approval of minority partners' board representatives
- Partners have separate voting rights
 - Supermajority voting requirements can be used to give minority partners veto rights
 - List of matters requiring board approval (or supermajority approval) likely to be shorter than in 50/50 deal
- One or more deadlock resolution mechanisms

Typical Governance Structures - Considerations

Partners using one of the typical joint venture governance structures should consider the following:

- Board and partners' approval rights may overlap. Venture documents do not always clearly indicate if board or partner approval (or both) is required
- Consider limiting the number of matters partners must approve
 - Avoids delay
 - Fewer opportunities for partners with veto power to extract concessions
- Consider if there is a role for:
 - independent directors
 - board committees
 - advisory boards
 - third party deadlock “arbitrator”
- Consider the impact of fiduciary obligations on board decision-making



5. Governance Issues – Governing Boards & Management

Governance Issues –Board Fiduciary Duties

Board members' fiduciary obligations will impact board decision-making.

- Unless otherwise agreed, board members *may* have fiduciary obligations to all partners, not just the partner who appointed them
 - A partner may expect its board representatives to act exclusively in the partner's interest. Unless fiduciary duties are waived, the board *may be obligated to* act in the best interest of *all* partners
- Partners should consider whether to waive all fiduciary obligations of the board
 - Board members must still act in good faith
 - Limited waivers of certain fiduciary duties may be an option
- Certain issues may be avoided by giving partners direct decision-making authority

Governance Issues – Independent Board Members

Independent board members can play a role in joint ventures.

- More common in larger and multi-member ventures
- Appointing independent board members can:
 - Offer an independent perspective that may help resolve conflicts among partners
 - Provide special expertise partners may not have
 - In multi-partner ventures, represent the collective interests of partners that do not appoint their own board representatives
 - Elevate the stature or credibility of the venture by appointing industry experts or other prominent persons to the board

Governance Issues – Board Committees

Board committees are being used more and more often.

- Committees often facilitate careful, focused decision-making
- In many cases, committees are analogous to committees a public company board establishes – compensation, governance and audit
- Other committees can facilitate decision-making generally, such as executive committees, or in particular areas, such as technology committees
- Committees can add unnecessary complexity
 - Will using committees be consistent with voting requirements that board representatives of some or all the partners approve particular decisions?

Governance Issues – Advisory Boards

Many ventures are establishing advisory boards.

- Advisory boards enable partners to obtain expertise they lack, *e.g.*, in industry, technical or financial matters
- Allow partners to allocate fact-finding, community outreach or decision-making responsibility
- Advisory board members may be independent or affiliates of partners
- May be purely advisory or it may have authority to make certain decisions
- Outside advisory board members often request compensation
 - Will advisory board members receive equity in the venture? A profits interest (if the venture is an LLC)? cash?
- Need to be clear on whether the advisory board activities are covered by insurance

Governance Issues – Management Team

Partners want to play a significant role in selecting venture management.

- Power to select day-to-day managers of the venture is critical

Partners are experimenting with alternative arrangements to select key officers:

- Each partner appoints a CEO and the co-CEOs serve simultaneous or overlapping terms
- Partners take turns appointing the CEO, who serves for a stated term
- Each partner appoints 1 or more specific officers
 - Officers to be appointed by each partner can also alternate

Advantages of these arrangements include:

- Partners have more meaningful voice in day-to-day management of the venture
- Build a deeper management team

Disadvantages of these arrangements include:

- Complexity (especially if more than two partners)
- May enforce “separateness” rather than facilitate joint venture operation
- May cause officers to align with a partner (and its interests) rather than with interests of all partners and the joint venture



6. Governance Issues – Deadlocks

Governance Issues – Deadlocks

- Partners in a 50/50 venture often worry about how to deal with deadlocks
- Partners in other types of ventures also worry about deadlocks or the venture's inability to act if partners have veto rights
- Variety of mechanisms can be used to resolve these situations
- What kinds of deadlocks / inability to act due to the exercise of veto rights should trigger a resolution mechanism? Decision should be tailored for each venture
 - Can deadlocks occur on any board issue or only on particular issues?
 - Partners may limit triggers to deadlocks on significant issues, such as approval of the venture's budget or a change in the venture's scope
 - List of triggers is likely to be shorter or longer depending on severity of the consequences. For example, if a partner can terminate the venture due to deadlock, the list may be very short

Governance Issues – Deadlock Resolution Mechanisms

Partners often use one or more of the following deadlock resolution mechanisms:

- Bounce the decision upstairs
- Negotiation
- Mediation
 - Consider identifying the mediator in the venture agreement, or a process to select a mediator
- Arbitration
 - Consider identifying the arbitrator in the venture agreement, or a process to select an arbitrator

Governance Issues – Deadlock Resolution Mechanisms

Deadlock resolution mechanisms, continued:

- A third-party decision maker (not an arbitrator) named in the venture documents decides
 - This is an unusual resolution mechanism; usually used for industry expertise
- Sale of the venture company
 - Generally used only for the most significant problems
 - Raises additional issues: e.g., how will sale process be conducted?
What price must the partners accept in the sale?
 - Are the partners permitted buyers?
- Withdrawal
- Termination
- Funding effects

Governance Issues – Deadlock Resolution Mechanisms

Deadlock resolution mechanisms, continued:

- Buy/Sell: Either partner may initiate buy/sell process by offering to (a) buy the other partner's equity or (b) sell its equity to the other partner
 - Generally, the other partner must accept (a) or (b)
 - Alternatively, the other partner can make the same offers to the initiating partner, but at a higher price
 - Ideally, the partners have the same financial resources and condition



7. Exit Provisions

Exit Provisions - Make sure there is a way out

- Exit mechanisms include withdrawal, sale of the venture company, buy/sell provisions, put and/or call rights and termination of the venture
- Establish exit rights up front; can't predict how partners' bargaining positions will shift over time

Reasons to include exit mechanisms:

- Ultimate resolution if deadlocks are unresolvable / creates incentive to resolve deadlocks
- Allow withdrawals by non-defaulting partners if a partner breaches / deters breaches of the venture agreement
- Alternative for dealing with a change of control of a partner
- Provides more certainty to partner(s) who joined the venture in order to exit the business conducted by the joint venture in stages
- Provides an exit if, after a specified period:
 - Partners no longer believe the venture can fulfill its objectives
 - Partners want to monetize their investment by selling equity

Exit Provisions – One size does not fit all

When designing and negotiating exit provisions, keep in mind:

- The venture's purpose
 - Was it formed to give partner(s) the ability to exit the business of the venture company in stages? If so, right to initiate a sale process may be an appropriate exit mechanism, but not a call right
- Partners' investment horizons and liquidity needs
- Partners' respective financial resources
 - If one partner lacks sufficient resources to buy out the other, call rights or a buy/sell mechanism may not be equitable, or may need to be adjusted (e.g. price payable over time or through seller financing)
- Joint venture's financial resources
 - Will the venture be able to redeem equity from withdrawing partners?
- Applicable regulatory or contractual limits
 - Legal, accounting and contractual consequences if the identity or ownership percentages of the partners changes
 - Whether pricing of interests should vary depending on circumstances (e.g. FMV versus a discount if partner is withdrawing/has breached)

Exit Provisions – One size does not fit all

Exit provisions should address:

- Consequences of withdrawal under agreements between the withdrawing partner and the venture:
 - Technology licenses or real property leases
 - Commercial contracts such as distribution agreements or service/support agreements
 - Guarantees of venture debt or other obligations
 - Confidential information
 - Obligation to return or destroy confidential information
 - Withdrawing partner's ability to disclose or use venture's confidential information
 - Survival of restrictive covenants
 - Non-competition & non-solicitation
 - Withdrawing partner's right to continue to participate in economics of the venture



8. Shared Asset Issues

Shared Asset Issues

Shared assets exist or are created when:

- A partner retains rights to use assets it contributed to the venture
- A partner licenses or leases assets to the venture
- The venture gives rights to partners to use the venture's assets
- The venture and partners jointly develop assets
- A venture name or trademark is related to a partner's name or trademarks

If assets are shared, partners must resolve various issues:

- How is the use of tangible assets allocated among different users?
- Who pays to maintain the assets?
- Can the assets be sublet, subleased or sublicensed?
- Whether the assets can be encumbered by any user
- Who owns / can use improvements to the assets?
- Are there limits on how the assets can be used?
- Who controls decisions about the assets?

Shared Asset Issues

Will assets continue to be shared when a partner that owns or uses shared assets exits the venture?

What happens to shared assets if the venture terminates?

- Will the assets be sold?
- Will assets be given to particular partner(s)?
- If assets are not sold, how are they valued for purposes of distributing the joint venture's assets?

Shared Asset Issues

Additional issues if intellectual property assets are shared:

- Do the owner and other users have to inform each other of improvements?
- What rights do the owner and other users have to develop, use, license or transfer derivative works created from shared IP?
- Who defends and pursues infringement claims brought by or against third parties?
- Where and how will the shared IP be registered?
- What rights do partners have to use, license or transfer IP developed by the venture that is not derived from shared IP?

Summary and Q&A



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