

Structuring and managing joint ventures

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How do you structure and manage a joint venture? Bralek's Rule for Success states "Trust only those who stand to lose as much as you do when things go wrong". But whilst trust is a key element of a joint venture, it does not ultimately determine its success; and many other factors can have both a positive and a negative effect on the prospects for the success of a joint venture.

Leaving aside issues related to the quality of the joint venture partner, how can you structure the joint venture to best achieve your business objectives and to try to secure the performance that you want? What are the pros and cons of using a joint venture vehicle as against a contractual joint venture?

This article reviews some of the key issues in structuring and managing joint ventures against the backdrop of securing optimum performance from your joint venture partner and from the joint venture itself.

The first question in terms of structuring the arrangements is whether a joint venture is the best way for the parties to achieve their objectives. What are the commercial objectives: could a supply arrangement, for example, achieve the same objectives; could one party take the main contract and engage the other party through a sub-contract; could one party buy out part or all of the business of the other? Interestingly a survey published in the Harvard Business Review reported that where there is little overlap between the businesses of potential joint venture parties, a joint venture will be more likely to succeed than a merger, but where there is a reasonable degree of overlap between the parties' businesses, a merger is significantly more likely to succeed than a joint venture.

If a joint venture appears the best way forward, the next choice to be made is between a joint venture vehicle or a contractual joint venture.

The contractual JV works by the parties acting as independent contractors under a joint venture agreement which sets out all of their rights and performance obligations, and their relationship is based solely on the terms of that contract. That contract might be termed a co-operation, collaboration or consortium agreement, as well as a joint venture agreement; and these are not terms of art but simply reflect how the parties view the overall effect of their contractual arrangements.

For a joint venture vehicle, the basic choice is between a limited liability company or a partnership, with the choice often being tax driven – although it is important that, in considering the tax issues, the parties do not lose sight of the key legal distinction that a limited liability company does what it says on the tin and is a separate legal entity which allows the parties to limit their liability to their equity contributions, whilst partners have unlimited liability for the debts and liabilities of their partnership. The choice of limited liability company may extend to a consideration of the vehicles available in different jurisdictions and some of the 'hybrid' entities such as the UK's limited liability partnership or the Dutch cooperative.

In addition to the tax and liability considerations, what are the key issues relevant to the choice of structure? The parties should also give thought to:

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- whether the venture is for a single project or an ongoing business;
- the nature and sources of funding (cash and/or non-cash contributions; debt and/or equity; provided by the parties and/or from third parties; secured or unsecured?);
- the level of protection and control required over each party's interests in the assets;
- the likelihood of introducing further participants; and
- accounting requirements.

We then move to the management of the JV. Those charged with the management of a joint venture vehicle may find themselves in a potentially awkward situation in that they are appointed by, and expected to represent the interests of, one of the JV parties, and yet as directors of a JV company will owe fiduciary duties to the JV entity rather than to their appointee.

This situation is one for the parties to recognise and address from the outset. Key elements of the management of the JV to be recognised by the parties are:

- the JV is a separate legal entity and its directors will have fiduciary duties to that entity. Under English law the directors have a specific duty to act in good faith to promote the success of a company for the benefit of all of its members, and so certainly should not be expected to act as a cat's paw for their appointee;
- the JV can be managed by the parties' appointed directors, or those directors can act in a supervisory capacity over an independent executive management team: which is the preferred model?
- there is a distinction between the day to day operational management decisions to be taken by the management and those decisions to be referred back to the parties for shareholder approval. The JV agreement should therefore identify the 'reserved matters' which require shareholder approval – which may well be a more extensive list than those matters which legally require approval by way of shareholders resolution;

- the directors' duties in relation to conflicts of interest and confidentiality may mean that there cannot be a complete and transparent information flow from the directors to their appointing shareholders. The JV agreement should therefore address what minimum levels of reports and other information each shareholder is entitled to receive.

These considerations are relevant to all JVs, but the way in which they are addressed will differ not only based on the legal issues to be resolved but also depending on the respective interests of the parties in the JV particularly whether they have equal interests (eg a 50/50 JV) or whether one party has a controlling shareholding. The key questions that arise here are how the JV will be controlled (ie the balance of power between the two parties), what protections are provided to the party with the minority shareholding, and how any deadlock between the parties is resolved.

So it can be seen that even in a relatively straightforward two-party JV, the parties need to reach agreement on: those decisions to be taken by the directors; those decisions to be referred to the shareholders; those decisions requiring unanimous shareholder approval; and the mechanism for resolving a failure to reach an agreed decision at any of these levels. The parties also need to ensure that they understand the legal position under the law governing the JV and whether or not that legal position can be altered or overridden by their own arrangements.

With the first stages of the JV's lifecycle now in place, the parties have further work to do, because a properly structured and managed JV will look ahead to consider what happens when one or both parties wish to exit and/or to terminate the JV. These are different events and may arise in different circumstances and so require to be considered separately even if the parties ultimately conclude that they will address them in similar ways. For example, one party may be satisfied with the performance of the JV but wish to exit in order to realise the value of its interest; on the other hand, the parties may have a fundamental disagreement leading one party to wish to terminate the whole JV and all of its related obligations.

These events can be broadly categorised as follows:

- Termination by consent; for example, when the JV concludes its project or otherwise reaches the end of its natural life.
- Exit by one party; where that party will dispose of its interest in the JV either to the other party or to a third party. The right to sell out to a third party may need to be subject to pre-emption rights for the other party, perhaps coupled with drag and tag rights.
- A material breach by one party, or some other trigger event, which gives the other party a right of termination. Those other 'trigger events' do need to be considered, particularly the consequences of an insolvency or change of control of one party.
- Exit or termination as the mechanism to resolve a dispute. Whilst escalation or mediation may have a role to play in resolving a dispute, expert determination tends to be less popular in a JV agreement both because of the limited range of issues likely to be capable of referral and the potentially far-reaching consequences of the determination, and so exit or termination may well turn out to be the most likely resolution mechanism.

Whilst in relation to decision-making we saw that the parties needed to understand the legal position under the law governing the JV, conversely in relation to exit and termination the parties need to appreciate that there is usually no default legal framework to fall back on and so if they do not address these matters themselves the outcome may well be to stymie the JV. This should be borne in mind particularly if the parties consider leaving out all provisions on exit or termination from the JV agreement on the basis that commercial pressures which dictate the correct solution as and when such a situation arises: that can be a real 'bet the shop' decision made at a time when the parties have no visibility as to what that future situation will be.

If the JV is subject to a formal winding up process then there are statutory provisions dealing with matters such as the realisation of assets and distribution of any surplus, but if the parties have simply terminated their own JV arrangements then consideration must be given to the consequences of termination; for example, what happens to any assets of the JV, including both those assets previously contributed by the parties and assets generated by the JV itself which might include, say, foreground intellectual property rights.

If the JV becomes insolvent for any reason then the parties will need to be sensitive to the responsibilities, and potential liabilities, of their appointed directors, whose previous primary duty to act in the best interest of the company is now subject to a duty to have regard to the interests of the creditors which becomes of primary importance. The directors must be very careful, for example, not to favour their appointing shareholder over the interests of any of the creditors.

Finally, the parties may wish to set the JV in a wider context and consider, for example, what products, services, facilities or resources each party is to provide to the JV and what contracts are needed in relation to those supplies; and, on the other hand, what activities each party is allowed to conduct outside of the JV including, in particular, whether a party or its affiliates may compete with the activities of the JV.

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