The
VENEMA REPORT
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JOINT VENTURES
PART THREE OF THREE PARTS

by
William H. Venema
bill@thevenemareport.com

Part One of this three-part series addressed the structure of joint ventures, as well as various issues that the venturers should consider when deciding on the purpose and scope of the joint venture. Part Two concerned the financial aspects of the venture, including how it is funded, how the benefits are allocated, and how it is governed. This Part Three concerns various "back-end" issues, such as the sale of a joint venture interest, the failure of a venturer to honor its obligations to the joint venture, and how the joint venture ends.

CAN THE JOINT VENTURE INTERESTS BE TRANSFERRED? IF SO, HOW?

A General Prohibition on Transfer With Some Exceptions. Regardless of the form the joint venture takes, the venturers should decide whether and how their joint venture interests may be transferred and whether and how new members may be admitted into the joint venture. Typically, a venturer will want to limit the other venturer's ability to transfer its interest, although frequently each of them will be permitted to freely transfer its interest to a wholly-owned subsidiary or other affiliate, as long as the transfer causes no

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adverse tax consequences to the joint venture or any of the other venturers.

Transfers to Third Parties. Usually, the venturers will want to restrict third-party transfers in some fashion. Sometimes, they will want to prohibit such transfers completely. If that is the case, then the venturers should have the unilateral right to wrap up the operations of the joint venture and terminate its existence. Alternatively, the venturers might want to permit transfers to third parties only under certain circumstances.

Rights of First Refusal. If the venturers want to permit, but restrict, the ability of a venturer to transfer its interest to a third party, then they might make the joint venture interests subject to a right of first refusal that would permit the joint venture or the other venturers to buy the interest to be transferred. A right of first refusal may apply either from the inception of the venture or after a specified number of years during which no third-party transfers are permitted at all.

To facilitate the right-of-first-refusal mechanism, it might be helpful to require that third-party transfers must be solely for cash consideration and not include any other transfers of property or other consideration. There are other aspects of the right of first refusal that should be considered, as well, although they are beyond the scope of this article. These include such things as valuing the interest, time limits for making decisions, financing the purchase, and strategies for avoiding sham transactions that trigger the right.

The venturers should also consider that rights of first refusal render the joint venture interests virtually unmarketable, because potential buyers are unlikely to investigate and negotiate such an acquisition if the transaction could be usurped at the last minute by the joint venture or the other venturers.

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A Certain Kind of Buyer. As discussed above, the venturers might allow sales or transfers of the joint venture interests to affiliates of the venturers. In addition, they might decide to permit transfers to third parties that meet certain objective criteria. Among other things, such criteria could:

- require the transferee to have a specified minimum net worth,
- prohibit a transfer to a transferee that is a competitor of the non-transferring venturer, or
- prohibit a transfer to a transferee that is owned or controlled by foreign persons (particularly if the joint venture has government contracts).

Preventing the Circumvention of Restrictions. If the venturers decide to include transfer restrictions, then they should also consider how venturers might circumvent such restrictions, such as by making indirect transfers by means of a change of control of the venturer. This risk is especially acute if the venturer used a special-purpose subsidiary to hold its joint venture interest. A change of control could be defined in many different ways and could include other events, such as a transfer of stock of the venturer by the ultimate parent corporation of the venturer or a change in the management of the venturer in which specified individuals cease to be in control.

HOW CAN A VENTURER GET OUT OF THE JOINT VENTURE?

Joint ventures are usually not permanent arrangements. The McKinsey study mentioned in Part One and Part Two suggests that the average life span of a joint venture is about seven years. More than 75% of the terminating joint ventures in the McKinsey study were acquired by one of the venturers. In light of these statistics, venturers should

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always consider exit clauses.

Exits Under Certain Circumstances. Exit clauses will typically list the events that will trigger the right of a venturer to exit the joint venture. These triggers can include a change in control of one of the venturers or the parent of the venturer, the inability of the venturers to agree on a key issue, the failure to achieve an important business milestone, a breach of contract, or the arrival of a specified date after which either venturer can terminate the joint venture by delivering notice to the other venturer.

After the venturers decide on the triggering events, they will need to determine how the exit will take place after an event occurs. Such provisions could include the right to "put" the venturer's interest to the joint venture or the other venturers. They might also include the right to sell a venturer's interest to a third party, either subject to, or free of, restrictions such as those discussed above.

Buy-Sell Provisions. If a venturer is going to sell its interest to the joint venture or to the other venturers, then the value of the interest must be addressed. Often, "buy-sell" provisions are used to solve this problem. Pursuant to such provisions, one of the venturers sets a price for the interests, and then the other venturer must choose either to buy or sell at that price. These provisions should be used cautiously, however, because they are appropriate only when both venturers are just as likely to be the buyer or seller. If one of the venturers is more likely to be the acquirer, because the joint venture's business is more closely connected to the venturer's core business, or because the other venturer lacks the financial ability to back up a legitimate offer, then the buy-sell provision might not work as planned. Alternatively, valuation could be established by a third-party

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appraisal by a pre-selected appraiser who will be charged with determining a "fair price."

WHAT HAPPENS IF A VENTURER FAILS TO HONOR THE DEAL?

Venturers typically want to focus on the positive aspects of the joint venture, and so it is often difficult for them to consider in advance what should happen if one of the venturers fails to honor the deal. Nevertheless, the joint venture agreement should clearly specify what constitutes an event of default by a venturer and what the consequences of a default will be.

Resolving Disputes. It would be very unusual if the venturers never had a dispute. In all likelihood one of them will fail to honor all of the terms of the agreement. As with any contractual arrangement, there are two aspects to dealing with defaults:

(1) it must be determined whether a default has, in fact, occurred, and

(2) the appropriate remedy must be applied.

Joint venture agreements can include a variety of dispute resolution mechanisms, including litigation in a particular jurisdiction, arbitration, mediation, or other alternative dispute resolution forms. Whatever the mechanism, the venturers should agree upon it in advance, in order to avoid gamesmanship following an event of default.

Avoiding Disputes or Limiting Their Effect. To prevent disputes from escalating and jeopardizing the existence of the joint venture, venturers will often include a provision in their agreement that requires each venturer, before the venturer resorts to any dispute resolution process, to refer the dispute to certain specified managers of each venturer for resolution. Such an agreement would also include a provision that requires the venturers

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to continue to operate the joint venture while the dispute is being resolved.

The venturers might also want their agreement to include disincentives to default, such as liquidated damages provisions or specific-performance provisions. The venturers could also include provisions that permit the non-defaulting venturers to buy the interest of the defaulting venturer on pre-established terms, or to cause the dissolution of the joint venture, in addition to being compensated for any damages resulting from the default. The purchase price for such a buy-out provision could be at a specified discount from the fair market value of the interest. Alternatively, the fair market value of the interest could be determined by a pre-established formula or process, by the agreement of the parties, or by a third party.

As discussed above, venturers are often special-purpose subsidiaries. Accordingly, if the joint venture obligations of a venturer are guaranteed by a parent or other affiliate of the venturer, then the agreement should address circumstances or events with respect to such parent or affiliate that would also be deemed to constitute a default by the venturer under the joint venture agreement, such as the bankruptcy of a venturer's parent or affiliate.

HOW DOES IT ALL END?

As difficult as it is to get venturers to focus on providing a dispute-resolution mechanism in their agreement, it is even more difficult to get them to focus on how the joint venture will end. The joint venture agreement should specify what events, if any, will cause the joint venture to terminate. In addition, the venturers should consider whether

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they want to include a "termination for convenience" provision, pursuant to which a venturer can force a termination of the joint venture. Terminations for convenience can be fashioned so that they apply only after a set period of time has elapsed following the formation of the joint venture.

Normally, it is not in the best interests of the venturers to terminate the joint venture by terminating its business and winding up its affairs. Instead, it is usually preferable for one of the venturers to purchase the interests of the other venturers. The buy-sell provision discussed above can facilitate this process.

CONCLUSION

A joint venture can be a valuable and flexible method of pursuing a business opportunity. To be effective, however, it must be designed in a way that enables it to handle the many issues that it is likely to encounter. The foregoing discussion provides a sampling of what those issues might be.

The matters discussed in this paper involve a complex area of the law. Despite the length of the paper, it is not an all-inclusive discussion of the issues presented and does <u>not</u> represent legal advice. Accordingly, it should not be relied upon without consulting a qualified attorney.

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