Equity Joint Ventures

The Nuts and Bolts

By Matthew S. Churchill and Allain Andry

When a client seeks representation on an equity joint venture, there are eight primary structural considerations that provide the framework for documenting the venture: 1) initial capital contributions; 2) future capital needs; 3) cash distribution waterfall; 4) governance; 5) transfers; 6) exit rights; 7) restrictive covenants; and 8) affiliate transactions.

This article briefly discusses key issues in each of these areas by using the following illustrative joint venture transaction. Manufacturer, LLC (Manufacturer) has a division that manufactures auto parts and seeks an equity infusion to expand its operations. Supplier, LLC (Supplier) is a key supplier to Manufacturer and is willing to make a minority equity investment in concert with the execution of a long-term supply agreement. Manufacturer employs a key manager (Employee), who is critical to the success of the venture and seeks an equity incentive tied to future profits as consideration for entering into a long-term employment arrangement. The parties have agreed to form Newco, LLC (Newco) as the joint venture vehicle. Newco is organized as an LLC because of the structuring flexibility, pass-through tax treatment and limited liability protection offered by a limited liability company.

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Initial Capital Contributions

Manufacturer contributes the assets of its division to Newco in return for its membership interest. Manufacturer's key concerns related to this contribution are: 1) the contribution of assets for membership interests constitutes a tax free transaction to Manufacturer; 2) the contributed assets and going concern value of the business are adequately valued for capital account purposes; 3) Newco assumes the ongoing liabilities of the business, including contractual obligations, any indebtedness connected to the business and ordinary course working capital liabilities; and 4) consents are obtained from Manufacturer's applicable contractual counterparties to avoid any default by Manufacturer. If Manufacturer has other ongoing businesses that share assets or intellectual property, Manufacturer may seek to license or lease certain assets to Newco and preserve rights to those assets for its other businesses.

Supplier contributes cash to Newco in return for its membership interest and will be concerned about the relative valuation of its cash contribution to the value of the assets contributed by Manufacturer for capital account purposes. Supplier also will be focused on ensuring that: 1) all material assets of Manufacturer's business, including key tangible and intangible assets, permits, contracts and employee arrangements have been contributed free and clear of any liens (other than liens related to debt agreed to be assumed); and 2) the pre-closing liabilities of Manufacturer's business are retained by Manufacturer, with indemnity to Newco from Manufacturer.

Employee would typically be granted a "profits only" membership interest that has no initial capital account balance and only receives distributions after the capital contributed by Manufacturer and Supplier is returned to those entities. Employee would not typically contribute any capital for such a profits only interest and the grant should not create taxable income for Employee. Employee will be most concerned about the terms of his employment contract and benefits, any vesting requirements associated with the grant of equity and minimizing taxes related to the receipt of his equity.

Future Capital Needs

Manufacturer, Supplier and Employee should carefully consider whether the initial capital contributions described above will be sufficient to sustain the ongoing business and anticipated growth of Newco. If additional capital is expected to be needed, the parties should agree on how it will be funded or raised.

As the controlling member, Manufacturer will likely seek the greatest flexibility to call additional capital or issue additional equity in Newco to meet operating needs. Supplier and Employee will seek typical minority protections like capital contribution veto rights, capital contribution caps or approved capital budgets. Supplier and Employee may also seek preemptive rights or other anti-dilution protections with respect to new equity issuances.

In lieu of additional equity capital, the venturers may rely upon third party debt financing of Newco and/or permit members either to make loans to Newco on defined terms or to contribute debt-like preferred capital with priority returns.

Where mandatory capital contributions will be required, remedies for default need to be carefully crafted. The deep-pocketed members may seek substantial remedies for failures of members to contribute capital, including the right to buyout the defaulting member, to dilute the equity of the defaulting member or to permit the non-defaulting members to make a member loan to Newco to replace the defaulted capital.

Cash Distribution Waterfall

Given that freedom of contract among the members is a core principle of limited liability companies, the venturers have broad flexibility in crafting distribution mechanics.

Manufacturer and Supplier typically would receive distributions equal to a return of their capital prior to

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Employee receiving distributions on his "profits only" membership interest. Manufacturer and Supplier may also seek a priority "preferred return" (an amount calculated like interest) on their capital investment before distributions are made to Employee. After the priority distributions are made, the residual profits of the business are often distributed pro rata in accordance with membership interest ownership percentages.

Thus, the members may agree that Manufacturer shall own 60% of the membership interests, Supplier shall own 30% of the membership interests and Employee 10% of the membership interests for voting and residual distribution purposes, but the actual distribution waterfall may vary significantly from these pro rata ownership percentages.

Because of the operation of the cash distribution waterfall or a decision by the controlling members not to make cash distributions, members may be allocated pass-through taxable income related to Newco's operations without receiving cash distributions to cover the related tax obligations. Thus, Supplier and Employee, as minority members, may seek an agreement from Manufacturer to distribute cash pro rata to the members sufficient to cover their federal and state income taxes on Newco's allocated income. Such tax distributions are customarily treated as advances against distributions under the regular waterfall.

Governance

Most LLC joint ventures are governed by managers appointed by the members, and many venturers implement board of manager structures similar to a board of directors. For Newco, Manufacturer will want to ensure that its designees as managers constitute either a majority of the board of managers or hold votes equal to Manufacturer's 60% residual ownership interest in Newco so that Manufacturer will have general management control over the entity. Supplier and Employee will want to negotiate for their managers to have veto rights over certain material management decisions (*e.g.*, decisions on fundamental transactions, admissions of new members and incurrence of debt). As a 30% residual owner, Supplier is more likely to negotiate successfully for veto rights than Employee, who may only have protections related to fundamental transactions with an adverse economic impact on Employee.

The managers of Newco may have fiduciary duties under applicable state law. Fiduciary duties generally include a duty of loyalty to act in the best interests of Newco and avoid conflicts of interest and a duty of care to act as a prudent person would in similar circumstances. Certain states, including Delaware and North Carolina, allow members to expand, modify or eliminate fiduciary duties, although all managers will remain subject to a contractual duty of good faith and fair dealing. State law may also permit indemnification of managers or exculpation of managers' personal liability for breaches of fiduciary duty.

Manufacturer may seek to eliminate or limit applicable fiduciary duties due to its managers' ability to control Newco, while Supplier and Employee may have an interest in ensuring that robust fiduciary duties apply to all managers. Because of potential liability concerns related to fiduciary duties, members may seek to appoint entity managers that have limited liability protection rather than individual managers. Members may also seek to have fundamental decisions made by the members rather than managers, as members have more flexibility to act in their own interest without concerns about fiduciary duty constraints.

The presence of veto rights or equal membership voting rights can create deadlocks over management decisions for a joint venture. Deadlock often simply results in inaction, with the status quo past practice of the joint venture continuing forward. Venturers need to determine whether a status quo outcome is workable for all deadlock situations or whether deadlocks for certain fundamental decisions, if unresolved through informal dispute resolution procedures, should permit an unwind of the joint venture through a buy-sell or other exit provision.

Transfers

The joint venturers may craft broad prohibitions against the ability to transfer membership interests in Newco (*e.g.*, require the consent of all parties to a transfer) or provide significant transfer flexibility, including allowing for free transferability or the ability to transfer to third parties after a right of first refusal in favor of the other members.

As the controlling member, Manufacturer will typically seek a veto right over transfers and the ability to drag-along the other members if Manufacturer desires to sell Newco to a third party. Similarly, Supplier and Employee would seek the right to tag-along on any sale of Manufacturer's membership, *i.e.*, sell the same percentage of their interests on the same terms as Manufacturer is selling. Each member may also want to permitting affiliate and estate planning transfers.

All venturers should carefully review the transfer boilerplate provisions, as language on securities law restrictions, guaranty releases and tax terminations can create practical roadblocks to transfers.

Exit Rights

The joint venturers may identify and agree upon specific circumstances in which Newco or the other members will have the right or obligation to buy out a specific member. Those exit rights may take the form of time-based put or call options or redemption rights tied to breaches of certain fundamental transaction documents. For example, Manufacturer and Supplier may seek corresponding call and put rights on Supplier's membership interests at the end of the initial contemplated term of the supply agreement or in the event of any breach of the supply agreement. Both Manufacturer and Supplier will want Newco to have the right to redeem Employee's membership interests if Employee's employment with Newco ends for any reason, and Employee may seek a put right to Newco for his membership interests where he is terminated without

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any compensation to the original author. The API License further clarifies that developers must expressly obtain consent from the user for use of his/her name, likeness, or identifying persona.

This means that advertisers are ultimately responsible for the content of their tweets, retweets or favorites, as Twitter has not obtained any express rights for advertisers to use content on Twitter unless those advertisers are Twitter partners. Further, even if an advertiser were to become a Twitter partner and obtain a sublicensed right to Twitter content directly from Twitter, Twitter expressly does not purport to grant partners publicity rights through its API License and an advertiser would still be responsible for obtaining these rights on its own directly from the original poster.

In the only instance of a court's review of Twitter's TOS to determine whether the TOS grant any rights to third parties, the recent decision in *Agence France Presse v. Morel*, 934 F. Supp. 2d 547 (S.D.N.Y. 2013), found that Twitter's TOS grant content usage rights only to Twitter and its partners. In *Agence France Presse*, a photographer received $1.2 million in statutory damages as a result of the Agence France Presse and Getty removing the photographer's images of the Haitian earthquake from a third-party Twitter user's TwitPic account, falsely attributing the photos to the third party and then commercially licensing the photos to users of its service without the photographer's permission.

The court analyzed Twitter's TOS when weighing AFP's argument that it derived a license from Twitter's TOS as a third-party beneficiary and that the license provided by users in it allowed AFP/Getty to remove the photos and license them commercially to third parties. The court found that the TOS expressly granted a license to Twitter and its partners to use content posted on Twitter, but that the license would not extend to allow AFP and Getty to remove the photos and commercially license them. In the absence of additional case law and other specific guidance from Twitter, it appears Twitter does not grant a waiver or any form of license to advertisers who are not Twitter partners and that advertisers are technically responsible for securing all rights in the content that they share on Twitter whether through original tweets, retweets or replies to users, in the same way that they secure such rights in any other type of advertising material.

Conclusion

Undoubtedly, the safest course of action is to get consent from Twitter users to either reuse or retweet content where third-party rights may be implicated. However, the time and expense associated with clearing all rights in each and every Twitter post could result in an advertiser missing the mark in a rapidly evolving environment where spontaneity drives engagement and advertisers must be quick to act in order to remain relevant. The nature and scope of each advertiser's use of Twitter and its specific tolerance for risk will ultimately frame the basis for how an advertiser decides to engage on Twitter.

The first step toward a practical approach to risk mitigation on Twitter requires an advertiser's legal and marketing teams to initially set internal guideposts that restrict high-risk behavior and to set forth do's and don'ts for its regular Twitter promotional activities after a determination has been made about how much risk the company feels comfortable assuming when utilizing Twitter as a promotional tool.

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cause. The minority members will want to ensure that the net proceeds or a sale of all or a material part of Newco's assets will be used for a distribution, rather than reinvested at the majority's discretion.

Exit right valuations often vary due to the circumstances of exit, and such valuations may be tied to fair market value appraisals, with or without discounts for minority interest or lack of liquidity, or may be punitive in nature (*e.g.*, tied to the lower of fair market value and capital account balances) in the event the exit right is due to breach.

Restrictive Covenants

The joint venturers will need to consider the extent to which they are willing to be bound by restrictive covenants like noncompetition and employee and customer non-solicitation terms, including whether such restrictive covenants bind venturers for any period of time after they exit Newco. Manufacturer may seek broad noncompetition and non-solicitation provisions to protect what it views as its primary business, while Supplier may seek flexibility to supply other competitors. Employee will seek to ensure that he has employment flexibility if he leaves the joint venture. The validity of scope, territory and time limits of any restrictive covenants will be governed by state law.

Affiliate Transactions

The venturers should ensure that affiliate transactions, like the supply agreement, are either agreed upfront or are subsequently approved by disinterested members or managers who are not party to the transaction. Affiliate transactions should be separately and carefully documented and not squeezed into a brief covenant in Newco's operating agreement.

Conclusion

The upfront negotiation and careful documentation of the eight structural considerations discussed above will help joint venturers establish a practical framework for their business relationship. While the final business and legal documentation for a joint venture will vary significantly depending upon the business needs, sophistication and relative resources of the joint venture participants, as well as the industry in which the venture will operate, mutual agreement on these structural issues will provide a strong foundation for the venture and avoid surprises down the road.

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