JOINT VENTURES ARTICLE

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Best Practices for Documenting Your Joint Venture

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Joint ventures have been with us so long now that entrepreneurs may view them as old hat and pay scant attention to the nuts and bolts of forming a new one. Such familiarity should not lead a joint venturer to believe that the details do not matter. They do, because each deal is different and terms that fit the last deal may not work for the next one. This article highlights some of the best practices in documenting the business terms of a joint venture.

1. Pick the right time to form the joint venture.

It is possible for members to form their joint venture too early. That is, they may contribute unique assets or make unique commitments, such as signing a contract with a vendor, prior to confirming that the joint venture's business is viable and its operations will actually commence. An attractive alternative is to enter into a pre-formation agreement or letter of intent pursuant to which the members agree to work together to assemble all of the assets, entitlements and rights needed to commence the joint venture's operations (e.g., Member A secures a patent license), to share pre-formation costs and duties, and to define the ownership of any jointly created and funded assets. Then, they actually contribute unique assets (e.g., Member A assigns the patent license to the joint venture) and organize the joint venture only when its viability is largely assured.

2. Pay attention to the description of the joint venture's purposes.

The description of a joint venture's purposes can be a very important business point and should be considered up front by the parties. When the purpose of a joint venture is described too broadly, e.g., to permit "the conduct of any lawful business," there can be misunderstandings about the scope of the business of the joint venture when compared to the separate businesses of the members. For instance, a member may engage in a business that the other members consider competitive with the business of the joint venture and thus inappropriate, while the offending member may view the stated scope of the joint venture's business more narrowly. The best practice is for the parties to engage in thoughtful up-front discussions regarding noncompetition obligations and define the scope of the joint venture accordingly.

3. Provide a means to raise future capital.

As of the formation of a joint venture, the members should have contributed or made provision for all of the equity and debt capital or capital commitments that the joint venture is expected to need to achieve positive cash flow and profitability. However, projections not always being accurate, it is advisable to consider and negotiate the various permitted means to raise additional capital. For instance, if some members decline to make additional capital contributions, then other members may be authorized to make capital contributions to raise needed cash. Members (or some of them) may agree in advance to guarantee joint venture bank loans or may advance their own loans to the joint venture. New members might be admitted as another means of raising capital. Providing for alternative methods to raise additional capital will prevent members who are unable or unwilling to contribute additional funds from hamstringing the venture.

4. If you can name entities as managers, rather than individuals, do it.

The parties should consider taking advantage of limited liability company statutes which allow entities to serve as managers and thereby insulate individuals from liability as managers. Under many LLC statutes, managers have personal liability for wrongful distributions as well as exposure for breach of contract and breach of duties owed to the LLC. The best practice, if consistent with the culture of the organization, is to name entities as managers.

5. Consider decision-making and deadlock resolution procedures separately.

Even when one member of a joint venture owns a majority interest, the members often find it appropriate to negotiate a list of decisions requiring a super-majority vote, such as the approval of the annual budget or of a sale or dissolution of the joint venture. These provisions are common and reflect thoughtfulness about the joint venture's governance structure. But what will happen when super-majority approval of one of these enumerated decisions cannot be obtained? The best practice is to consider separately the list of decisions that require super-majority vote and the list of decisions that can trigger a deadlock resolution process. Many disagreements simply do not need to be resolved and do not justify a break-up of the joint venture. For instance, failure to obtain super-majority approval of an expansion of business operations should result in no expansion, not in a deadlock. Otherwise, the joint venture members are at risk that a member will engineer deadlock on an issue to trigger a purchase or sale right.

6. Decide what happens if a member breaches its obligations.

If the joint venture agreement is silent, the parties have contract claims against a breaching party, but generally speaking, a lawsuit is not a particularly efficient or satisfying remedy. It is far better to specify remedies and to indicate whether or not those remedies are exclusive. Specified remedies for breach may include a purchase right that forces out the breaching party, a loss of voting rights, a loss of the right to appoint joint venture managers, and/or reduction in the breaching member's ownership interest. These remedies may be tied to specific breaches, such as a breach of the obligation to contribute capital or not to compete, or may be general as to all breaches.

7. Set the ground rules for competition against the venture.

Members always should consider the extent to which they are allowed to compete with the joint venture, to solicit its employees, and to use its confidential information for competitive purposes. The joint venture agreement should specify precisely what the members cannot do or eliminate any such restrictive obligations. In addition, when a joint venture agreement contains purchase options or obligations or other provisions under which one member may exit the joint venture, the parties should agree in advance whether that exiting member will be bound by a noncompete covenant after its exit. If so, they should define the scope and duration of that noncompete. Otherwise, the valuation of a member's interest upon exit will be uncertain. The parties also should consider whether the joint venture needs direct noncompete agreements with individual owners of a joint venture party, because merely restricting a special purpose entity whose only asset is its joint venture membership interest does not get the job done.

8. Pay attention to affiliate issues.

Many joint venture agreements contain transfer restrictions but omit provisions dealing with indirect transfers such as a change in ownership or control of a member. Also, an operating agreement may permit transfers to an "affiliate," but may define that term in a manner that allows an indirect, and unintended (from the point of view of the other members) change of ownership of a member. The best practice is to draft transfer restrictions that deal with both direct and indirect changes in ownership and control.

Frequently, members in a joint venture have business relationships with the joint venture independent of their status as investors, such as providing it with goods or services. Similarly, an individual investor may be an employee or consultant to the joint venture. It usually is advisable to document these relationships separately in a written agreement as you would with an arm's length stranger. The members also need to consider whether cross-defaults are appropriate (i.e., whether a default or breach of one agreement should trigger a default of breach of one or more separate agreements) and whether a member's participation in the joint venture should terminate or change if that business relationship ends.

9. Consider whether multiple joint ventures should be integrated.

When joint venturers participate in multiple ventures, consider whether a member's exit from or default in one venture should trigger an exit from or default in all ventures. Assume, for instance, that three individuals organize two separate joint ventures to conduct related businesses. They may operate the businesses through two joint ventures rather than one because they may want to allocate ownership differently in the joint ventures. If one member breaches the obligations owed under one joint venture agreement, and as a result, the other members have the right to force its exit, they also may want to force its exit from the other joint venture. On the other hand, where the parties form multiple joint ventures that engage in unrelated businesses, an exit by a member from one probably should not result in a forced exit from the others.

In conclusion, joint venturers should not ignore the fine print. By identifying key business issues and then addressing them, the joint venture is better poised for long term success. In the rush, excitement and optimism of the pre-formation period, joint venturers should always plan for what happens if the honeymoon ends early.