Insights Conversations: Joint Venture Agreements

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Joint venture (JV) arrangements offer parties a number of benefits and opportunities they wouldn't be able to realize on their own. However, because a poorly drafted JV agreement can present significant pitfalls, careful drafting is essential. Delaware corporate partner Allison Land identifies some of the common issues that can arise, including with the scope of agreements, management responsibilities, lenders' rights and more.

Let's start with the scope of a JV. What are some of the challenges that companies may face if a JV agreement doesn't define the scope precisely enough?

The parties need to think about what types of assets the JV may acquire and what business it may conduct over the course of the JV arrangement. Companies should consider growth and acquisition opportunities at the outset, and any potential for expansion should be drafted into the JV's business purpose clause so as not to overly limit the JV's scope or create the need for future amendments and protracted negotiations that could impede future opportunities. On the other hand, if the JV parties agree that certain assets or businesses should fall outside the scope of the JV's business purposes, that should be spelled out in the agreement to avoid future disagreements.

Also, a well-drafted purpose clause often will govern the parties' obligations under noncompetition clauses. If the parties are expected to conduct the agreed-upon line of JV businesses or own the agreed-upon type of JV assets only within the JV itself, and not outside the JV, the agreement must specify that. The purpose clause also must be crafted carefully so the parties can conduct businesses outside the venture that do not fall squarely within the JV's scope. For example, it may be necessary to conduct related regulated businesses outside the JV, so the JV agreement should explicitly exclude such businesses from its purpose clause.

As the parties consider the purpose clause of the JV agreement, how does that process impact the structure of the JV?

Depending on what parties expect of the JV, different structure possibilities exist. One option is to utilize a "series" structure when the parties anticipate that the JV will own or acquire multiple business lines, assets or asset pools. Under such a structure, the JV segregates different businesses, assets or asset pools into various series of the JV (similar to divisions). If the statutory requirements of public notice and separate recordkeeping are met, the assets of each such series will be protected from claims by creditors of the other series and of the JV entity generally.

Each series may issue separate equity interests, which can be owned by the same JV parties or by different or additional owners, and the equity in each series can be held by the parties in percentages different from those in other series. Different management rights for each series also can be established, and each series can be treated as a separate partnership for U.S. federal income tax purposes and can elect different tax or accounting treatment (such as partnership or corporate taxpayer status and/or cash or accrual accounting basis).

Another relevant component of a JV's structure is the role of management. What are the important considerations in that area?

Often in a JV, each party has the right to designate a specified number of board members. Issues to address include such board designees' relative voting rights, matters that require supermajority or unanimous approval, and reductions in the parties' board designation rights upon certain events, such as a reduction in a JV party's ownership level over time or if a JV party fails to meet a capital call or otherwise breaches the agreement. If management will be vested exclusively in the board, care should be taken to expressly override any statutory default voting standards. When JV parties have the right to designate board members, the JV agreement often will provide that such designees owe fiduciary duties only to the party that designated him or her. While fiduciary duties may be restricted, expanded or eliminated under Delaware law, the language must be clear and unambiguous in order to be effective. If there is a controlling partner or member, parties must consider whether to restrict, expand or eliminate such party's fiduciary duties and expressly address these points in the agreement.

Often, the JV agreement will address procedures for approval of affiliate transactions or other conflicts of interest, such as a "conflicts committee" comprised of disinterested board members. When such a mechanism is properly defined and utilized, it may shift the burden of proof or create a presumption of good faith in the event of a challenge. However, the JV agreement must carefully define the duties and appropriate standard of review applicable to such a committee. In its recent decision in *In re: El Paso Pipeline Partners, L.P. Derivative Litigation*, the Delaware Court of Chancery found a breach of the partnership agreement, notwithstanding the agreement's requirement that the conflicts committee "subjectively believe in good faith that the transaction was in the best interests" of the partnership, resulting in a damages award of $171 million. For more on this decision, see http://www.skadden.com/insights/managing-related-party-transactions-yieldco-and-mlp-vehicles-after-el-paso-pipeline.

What rights do lenders have, and how should a JV agreement address those rights?

Where the JV intends to finance its business with debt at the JV level, or in a subsidiary, the parties should carefully consider the lender's rights in the context of the JV agreement. Under Delaware law, creditors of a JV that is formed as an LLC cannot bring derivative suits against managers, even when the JV is insolvent. But lenders have become creative in establishing their rights through provisions in the JV's governing agreement and/or the financing agreements. One issue to consider is whether the lender will have any consent rights over matters such as asset sales, mergers and amendments to the JV agreement. Lenders also may require documentation, executed upon closing of the financing, admitting the lender or its designee as a member of the JV in the event of a default.

What are some of the other key factors that can arise in JV agreements?

When drafting JV agreements, parties should focus on areas that can present common pitfalls. For example, transfer restrictions can result in a trap for the unwary. A JV agreement that neglects to address indirect transfers (*i.e.,* a transfer of the entity that holds a party's JV interest) could undermine the effectiveness of direct transfer restrictions. In other situations, the agreement may prohibit all indirect transfers without consent of the other JV parties. Often the parties are later surprised to learn that such a provision could prevent that party from effecting an upper-tier change-of-control transaction. A well-drafted agreement might otherwise permit the change of control to occur but provide a buyout right of the changing party's JV interest. Similarly, an "ipso facto clause" (a clause that purports to forfeit a party's JV interest upon initiation of a bankruptcy proceeding of such party) has been held unenforceable and should be avoided in favor of less draconian provisions.

Another area of focus should be limitations on access to information such as books and records. The JV agreement should spell out each party's right to receive reports from the JV, and to access its books and records. If there are to be any limits on access to these documents, they must be clearly and unambiguously provided in the agreement. While, under Delaware law, the members/partners are entitled to full access to books and records, the JV agreement may impose "reasonable" restrictions on such access. However, such restrictions should be crafted so they are in fact reasonable, in order to reduce the likelihood of success of any challenge.