Joint Ventures 101:
Objectives, Structure, Economics & Control

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What is a Joint Venture?

What is a Joint Venture?

- A joint venture is a cooperative venture between two or more companies, often with different constituencies and different objectives.
- Fundamentally different from other M&A-type transactions because the parties continue to share economic risk and will still be "tied together" after closing.
- Parties often contribute different assets to the venture – som combination of contractual obligations, hard assets, 'soft asse and cash – and often have different goals with respect to the venture.

Joint Venture Types and Examples

- *Joint Project*. Two companies decide to build and own a new project together.

- *Upstream/Midstream*. An E&P company agrees to dedicate i production to a new project and contemporaneously buys a minority interest in that project.

- *Financing*. A private equity fund agrees to finance a new proj by investing 'directly in the asset.'

Joint Ventures: The Big Questions

- What will the JV's business be?
- What is the JV's relationship with its owners?
- How will the JV be funded?
- How can or must the JV pay its owners?
- How are business decisions made, and by whom?
- How are disputes handled?
- What is the exit strategy for either or all owners?

Joint Venture Objectives

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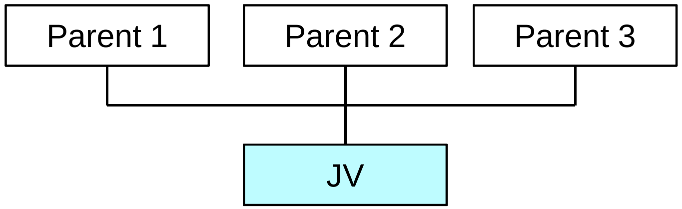
Objectives of Joint Venture Parties

- Typical Objectives
  - Strategic alliances / synergies
  - Project financing
  - Risk / cost apportionment
- Other Potential Objectives
  - Investment for potential upside
  - Access to management
  - Access to technology / assets

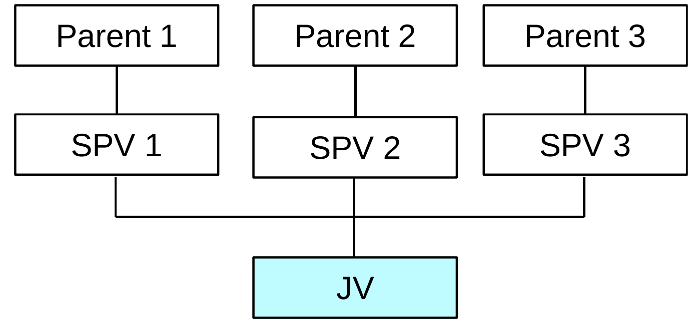
Structure Considerations

Typical Joint Venture Organizational Structure

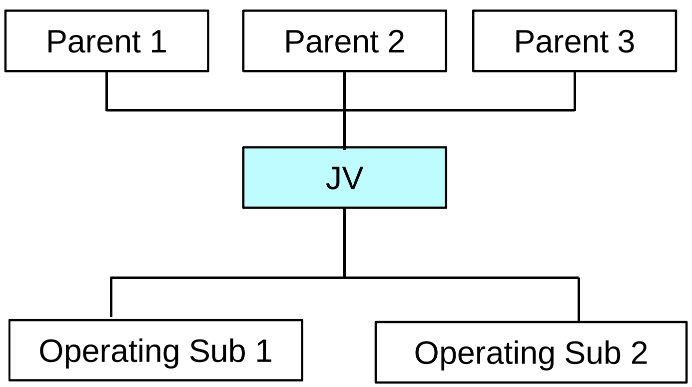
“Plain Vanilla”



“Ownership through SPVs”



“Holding Company / Operating Company”



Joint Venture Org Structure: Fundamental Drive

- Tax
  - Pass-through or corporate
  - Sale treatment
- Liability Concerns
  - Will the owners or management owe fiduciary duties?
  - General partnership or limited liability vehicle
  - Long-term obligations
- Reporting / Financial Obligations
  - Consolidation of financials
  - Financial assurances

- Regulatory Considerations
  - Antitrust
  - Other
- Economic Considerations
- Control Considerations

Economic Considerations

Joint Venture Economic Issues: I

- <u>Who is contributing what?</u>
  - Is anyone contributing assets?
    - What are they worth?
    - Is the contributor making representations & warranties?
    - What happens if there is a breach?
  - What additional capital contributions are required?
    - Is there an approval requirement, or are some contributions automatically required?
    - Are there any exceptions (i.e., matters for which the owners must contribute capital without any approval requirement)?
      - e.g., Emergency expenditures or required upgrades
    - Note that this is where a parent guarantee or other credit support is importan

Joint Venture Economic Issues: 2

- <u>Who is contributing what (cont.)?</u>
  - What happens if an owner does not contribute?
    - Dilution / penalty dilution
    - Deemed loan secured by ownership interest and distributions
      - This can be useful where equity ownership percentages are not directly proportional to economic ret
        and the counterparty is creditworthy.
    - Buyout / discounted buyout
    - "Sole risk" concept

Joint Venture Economic Issues: 3

- <u>Who will have what continuing obligations?</u>
  - Will an owner (or its affiliate) construct and/or operate the JV's assets?
    - What are the economic arrangements?
      - Compensation / reimbursement
      - Liability standard
  - Will the owners be permitted to compete with the JV, and must they first offer 'business opportunities' to the JV?
    - Geographic limitations?
    - Business area limitations?
    - Antitrust concerns?

- <u>Who will have what continuing obligations (cont.)?</u>
  - Can the JV contract or transact with an owner (or use shared services) and, if so, on what terms?
    - Approval by unaffiliated owner(s)
    - “No less favorable than” third party arms-length
  - Will an owner (or its affiliate) have ongoing commercial arrangements wi the JV?
    - Are any modifications pre-approved?
    - What approvals are necessary to modify?
    - Does breach of commercial arrangements affect equity ownership or right to distributions?

Joint Venture Economic Issues: 5

- <u>Who will have what continuing obligations? (cont.)</u>
  - May an owner (or its affiliate) have commercial arrangements with the JV
    the future?
    - Are any economic terms pre-approved?
    - What approvals are necessary to transact?
    - Does breach of commercial arrangements affect equity ownership or right to distributions?
  - Will an owner have any obligations for JV-level financing?
    - Project finance (often non-recourse)
    - Parent guarantees / equity commitments
    - Clawbacks

Joint Venture Economic Issues: 6

- <u>Who gets what, and when can they get it?</u>
  - Must the JV pay periodic distributions, or is approval required?
  - Who determines the amount to be distributed?
    - “Available Cash” / “Cash Reserves” concepts
    - Tax distributions
    - Statutory requirements (cannot make the entity ‘insolvent’)

Joint Venture Economic Issues: 7

- <u>Who gets what, and when can they get it?</u>
  - Are owners' commercial arrangements with the JV tied directly or indirec those owners' rights to distributions?
    - For example, if each owner has a separate class of equity for which distribut are tied to profits under a capacity lease with the JV to which that owner or it affiliate are party.
    - Accounting and tax complexity
  - What is the character of the parties' expected returns?
    - Preferred returns
    - Multiple classes of equity
    - Debt structures
    - Remember to consider all other cash 'leakages'

Joint Venture Economic Issues: 8

- When can an owner be diluted?
  - Sale of new equity (can anybody else join the JV?)
    - Vote/approval required?
    - Minimum pricing?
    - Preemptive rights?
  - Failure to contribute called capital
    - Straight dilution vs penalty dilution (discussed previously)

Joint Venture Economic Issues: 9

- How can an owner liquidate/lay off its investment?
  - Transfer Restrictions
    - Consent of all (or some) non-transferring owner(s)
    - Specific transferee limitations (creditworthiness standard, no competitors)
    - Business-specific requirements (e.g., governmental approvals, credit suppor
  - Right of First Refusal / Right of First Offer
  - Drag-along Rights (where selling owner can “drag” the other owner(s) al and force a sale)
  - Tag-along Rights (where other owners can “tag along” with a selling owr and force a purchase)

Joint Venture Economic Issues: 10

- <u>How are conflicts of interest and competition dealt with?</u>
  - Default LP/LLC Rule: Members and managers owe traditional fiduciary d (including a 'duty of loyalty'), which can be altered by the terms of the LL agreement
    - Business opportunity doctrine
  - Options:
    - "Freedom to compete" waiver of business opportunity doctrine
    - Waiver of fiduciary duties
      - Note there is a distinction in what may be waived in Delaware vs Texas

Joint Venture Economic Issues: II

- <u>How are conflicts of interest and competition dealt with (cont.)?</u>
  - If there are officers / managers / board members, do they owe duties to t JV or to the member that appointed them / for whom they work?
  - What approval / threshold is required for affiliate contracts?
    - Unaffiliated member approval
    - “No less favorable than third party/arms’ length”
  - What rights does the JV have regarding any owner that is providing serv to, or otherwise a contract counterparty with, the JV?
    - Is a breach a JV issue as well as a contract issue?
    - Is enforcement optional? Who controls?

Control Considerations

Joint Venture Control Issues: I

- <u>How is the JV managed?</u>
  - If there is an operator, extent to which authority is delegated
    - Operator would handle most administrative and operational matters, with the partners having specifically defined veto rights
  - Member-managed
    - Management committee/board of representatives
    - Voting power typically equals membership percentage
    - Meeting and process requirements
    - Typically no fiduciary duties

Joint Venture Control Issues: 2

- <u>How is the JV managed (cont.)?</u>
  - Board / Manager-managed
    - Often where JV will operate as a stand-alone company (i.e., with separate management, etc.)
    - More likely to have traditional fiduciary duties (or something like them)
    - Often looks more like traditional corporation (board & officers)
  - Budget matters
    - Annual operating budget (with ‘default budget’ where deadlock exists)
    - Capital budget to address long-term projects

Joint Venture Control Issues: 3

- <u>Who has veto rights over what?</u>
  - Typical areas of discussion for veto rights:
    - Budgets
    - "Fundamental" changes (merger, sale of all or substantially all assets, chang
business, withdrawal, dissolution, etc.)
    - Sale of equity
    - Specific strategic issues for JV or owners
    - Affiliate transactions
    - Capital expenditures or projects
    - Incurrence of indebtedness or guarantee (sometimes above a threshold)
    - Material contracts
    - Changes in pricing structure
    - Litigation matters (sometimes above a threshold)
    - Lobbying or contact with government agencies
  - Holding company structure would require control of sub behavior

- <u>What, if any, minority protections are there for small owners in a multi-member JV?</u>
  - Supermajority or unanimous approval requirements (often covered by th
“veto rights” discussion)
    - Amendment of LLC/LP agreement (or prohibit amendments that negatively a
disproportionately affect a member without that member’s consent)
    - “Fundamental” changes
    - Some affiliate transactions

Joint Venture Control Issues: 3

- <u>What happens if the owners disagree?</u>
  - “Deadlock” provisions
    - Can apply generally or only to certain ‘fundamental’ matters
  - Often, nothing happens
    - Parties have to come to commercial agreement or the veto wins
  - Can provide for buyout or ‘put’ right in the case of a deadlock
  - Or a “shootout” (works best in 50/50 but can be adjusted)
    - Either member calls a shootout
    - That member offers to buy out the other at a fixed price
    - The other member can either sell at that price, or buy the offering member o at that same price
      - This is perceived as a fair process but can be exploitative if a member has a liquidity issue at the tim shootout occurs.

Questions?

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