Structuring Successful Joint Ventures: Navigating Formation, Capital, Control and Other Complexities

Selecting the Right Partner and Legal Structure, Negotiating Corporate Governance

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Roadmap

I. Types of JVs

II. Is a JV entity necessary?

III. Selecting a JV partner

IV. Determining the best legal structure

V. Cash in / Cash out & the Business Plan

VI. Governance and control issues

VII. Allocating financial & legal liabilities

VIII. Ancillary agreements

IX. Exit and other unwind considerations

X. Considerations for international JVs
Negotiating & Structuring the Joint Venture

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Types of JVs

- JVs come in all shapes, sizes and flavors.

  a) Financial vs. Commercial

  b) Focus here is commercial joint ventures between two or more strategic parties

  c) Given the 90 minute time restraint, the content of this presentation has been adjusted accordingly
Is a JV entity necessary?

- **KISS**

- If a contract can capture the duties and rights of the parties accurately and limit risk acceptably, an entity may be unnecessary.
  - No need to assemble a new management team or set up and capitalize a new entity.
  - One less party to deal with.
  - Easier (maybe) to untangle if things go badly.
Is a JV Entity Necessary?

- Usually a novel endeavor, requiring a combination of technology, talent, market access or capital the participants can’t (or don’t want to) garner individually.

- Often a product or service that is:
  - An “orphan”
  - Risky/difficult
  - Hot
Is a JV Entity Necessary?

- **Advantages:**
  - Possibility of a sum greater than the parts
  - Limits corporate level risk
  - May present tax or accounting advantages
  - Entity can be funded, shut down or sold independently of the parents with minimal disruption.
  - Publicity and broader awareness due to unusual multi-party collaboration? Multi-party branding cache?
Is a JV Entity Necessary?

- **Disadvantages:**
  - Complexity (and expense)
    - Multiple parents—challenges of governance, differing strategic, technological, economic, PR/messaging and tax/accounting objectives
    - a third party is born—interests are not necessarily aligned with its parents
    - Myriad of “what ifs” need to be considered
  - High failure rate—from 35 to 90% reported in various studies
    - may just reflect the level of challenge of more complex ventures requiring collaboration.
  - Antitrust, regulatory concerns
Selecting a JV Partner

- Economic success of the JV

  a) One of the most important factors in the success of a JV is the inherent economic viability of the venture itself. The success of the venture will reflect on the JV parties.

    1. If one has a very successful JV, the other JV partner is often viewed as good.

    2. If one has an unsuccessful JV, the other JV partner is often viewed as not so good.

  b) Transactions that have substantial economic risk heighten the concern about selection of a JV partner.
Selecting a JV Partner

- JV Experience

a) Does the proposed JV partner have experience with JVs?

b) Those companies that have a lot of experience with sophisticated strategic JVs bring that experience to the transaction. There is a far greater probability of success with those who have that experience than those who do not. Some companies have substantial JV experience. (Note that there are certain countries in the world where JVs are the predominant vehicle for doing business by outsiders.)
c) Those companies that do not have experience with sophisticated strategic JVs may bring distrust or a lack of confidence to the transaction. The mere lack of experience dealing with the plethora of novel issues inherent in JVs can lead to considerable frustration levels and higher failure rates.

d) The lack of experience factor can be problematic even for those companies that otherwise would appear to be excellent JV partner prospects.
Selecting a JV Partner

- JV Track Record
  
a) What is the track record of the proposed JV partner?

b) There is a reason that some companies make good JV partners and some do not. Be wary of those proposed JV partners who have a history of problem JVs, especially with limited JV experience. A history of problem JVs is a serious red flag for many companies.
c) To be a good JV partner, it requires the ability to be extremely flexible and understanding of the other JV partner’s point of view, requirements, issues, etc., with a willingness to try to work with the other JV partner to reach mutually beneficial resolution on most business and legal issues. We all know that there are some companies that simply cannot help themselves and want to take advantage of the other party on every business or legal issue.

d) This is a matter of business diligence.
Selecting a JV Partner

Experience in the Business

a) JV transactions, especially complex strategic JV transactions, are not for the faint of heart. A good JV partner is one who has very solid depth in the specific business that it brings to the transaction.

b) While using JVs to break into new markets in the same business is relatively common, using a JV to break into a completely new business has a lot of risk.
Selecting a JV Partner

Can the JV partner deliver?

a) What does the other party bring to the JV, and can it deliver the goods? This is often discoverable during the due diligence phase of the JV.

b) Be wary of the proposed JV partner who is egregiously coy in sharing information that goes to the heart of the venture. This is especially true for key Business Plan metrics. Be especially wary of the proposed JV partner who does not deliver on crucial metrics that go to the heart of the Business Plan during the diligence phase of the JV.

c) The proposed JV partner who hides or delays delivery of key data during the due diligence and/or Business Plan development phase may not have the promised “goods”, casting doubt on the viability of the Business Plan. Inability to deliver the "goods" on vital metrics to the Business Plan can be a killer to the success of the JV.
Selecting a JV Partner

- Competitors

a) Competitor issues bring special challenges to JVs, including with the issue of “trust.” Those challenges do not necessarily mean, however, that a competitor is not a good JV partner under the right circumstances.

b) Be wary of a competitor who will gain access to core, confidential competitive information that can be used outside of the JV to your material detriment. While “clean teams” can be used and the attorneys can build in restrictive covenants and other legal protections, once sensitive information is leaked to a competitor, long term permanent damage may be done.
Competitors cont.

c) While statistics are not available, some competitors may use limited JV projects as a window into their competitors for reasons that go beyond the JV.

d) A JV with a competitor should be considered only if the business case for the JV is compelling and where the parties can build in sufficient protections for antitrust and competition concerns. Where the business case is compelling, JVs with competitors can be used very effectively to reduce product costs, pool resources or penetrate markets.
Selecting a JV Partner

- **Deal Posture – “Heads I Win, Tails You Lose.”**

  a) A lot can be learned about a proposed JV partner through the negotiation of an MOU or LOI transaction documents. Hard nosed, old school New York style “Mine, mine, mine. I get everything. You get nothing. My way or the highway” negotiating tactics on every material issue by one JV partner are rarely endearing to the other JV partner. Be on the lookout for this type of behavior, because it will likely be the same behavior that you will receive from that JV partner throughout the life of the JV. Note that some businesses simply just can't help themselves and these attributes are revealed almost immediately.
b) The ability to be reasonable, to compromise, to find creative solutions and common ground, are characteristics of successful JV partners. Companies that lack these characteristics are typically not good JV partners (absent a compelling business reason to the contrary).

c) Make a distinction between the transaction teams (the outside and inside counsel and business development teams) and the JV partners’ senior management and the relevant JV managers “on the ground”.

d) There is sometimes a completely different working relationship between the transaction teams (who don’t seem to have cooperative spirit) and senior management and the relevant managers on the ground. While the posture of the transaction teams may be a good indicator of whether they are a good JV partner, a better indicator of a good JV partner is how well the senior management teams and the relevant JV business managers on the ground on all sides get along rather than the transaction teams.
Selecting a JV Partner

Know Your JV Partner

a) Most JV partners already know their proposed JV partner. In some instances, however, the proposed JV partner may be new to the other JV partner. Before engaging in a transaction with such a proposed JV partner, a substantial amount of business due diligence should be conducted. Among the many obvious questions to be answered include:

1) What is the financial health of the proposed JV partner?

2) How much experience does the proposed JV partner have in the type of proposed JV?
Know Your JV Partner cont.

3) Does the proposed JV partner have a history of failed JVs?

4) How litigious generally is the proposed JV partner? (A search of court records in relevant jurisdictions could be very revealing question.)

5) Does the proposed JV partner have a history of tort claims against it or punitive damage levied against it?

6) Etc.
Selecting a JV Partner

Local Markets

a) JVs are the predominate form of doing business in some countries or markets. When selecting a JV partner in these countries or markets, reliable local experts in the JV business space can be of great help in obtaining intelligence in selecting JV partners.

b) There are companies that specialize in locating and identifying JV partners in certain countries or industries.
Selecting a JV Partner

■ The Test JV Partner

a) Sometimes a company will enter into a JV with another party primarily to determine whether or not the other party would be a good JV partner (without revealing this intention to the other JV partner).

b) If all goes well, then there would potentially more important JV opportunities for the other party. If all does not go well, then at least the damage would be limited to the “Test JV”.
Determining the Best Legal Structure

- **KISS**
  - If a contract can do the job, an entity is unnecessary.
  - If an entity is needed, structure should:
    - Require transparency, but not too many parental control mechanisms
    - Prevent deadlock (avoid 50/50 ownership, evenly split board)
    - Encourage collaboration, but assign clear responsibilities
    - Create appropriate incentives for success
Determining the Best Legal Structure

• Tax and accounting often drive entity structure
  – often dictated by the partners’ desire to minimize tax, obtain optimal accounting treatment.
  – Hard to generalize—sometimes tax pass-through is important to utilize losses, sometimes the partners want to hold equity in a C corp to defer or reduce the tax on gains.
Determining the Best Legal Structure

• Other General Points to Consider
  – How Important is Parental Supervision?
    • A limited partnership limits participation of LPs
    • An LLC can be extremely flexible in defining governance rules
  – What Structure Best Accommodates JV’s Objectives?
    • Management equity, control?
    • Exit? (dissolution, acquisition, going public?)
    • Attractiveness to outside investors, acquirors?
The Business Plan & Cash in / Cash Out

- The Business Plan

a) The Business Plan is a vital center weight for both business and legal issues. It is central to determining JV valuation (and therefore allocation of equity between the partners), and the various fundamental components of the JV, such as units of production volume, product direct and variable costing, JV ramp-up costs, capex requirements, product transfer pricing, product margins, product allocations to the JV partners, milestones, performance targets, beginning working capital requirements, overall profitability, profit and loss allocations, rate of return for approval purposes, projections, etc.
b) Why is the Business Plan presented in an outline of “legal” issues concerning JVs? Except for basic, routine, ordinary course JV agreement provisions and issues, most of the legal issues presented during the course of constructing a JV are derived in one way or another out of the Business Plan negotiations. Most of these issues will be unique to the JV, have no "out of the box" solution, and will require substantial negotiation and whole cloth drafting.

c) The typical Business Plan consists of a pro forma opening JV balance sheet, and multi-year earnings, cash flow and cap ex projections as well as the assumptions underlying the projections.
The Business Plan cont.

d) It is strongly recommended that the Business Plan be attached to the primary JV document (absent good reasons to the contrary) to act as a driver for both business and legal discussions.

e) The Business Plan should also take into account the cash-in flow needs of the JV and cash-out flow of the JV, as discussed below.
The Business Plan & Cash in / Cash Out

- Cash in – External financing

  a) External financing works predominantly (although not exclusively) in circumstances where the JV constitutes a viable, standalone operating business. Also, external (and not JV partner) financing is desirable in connection with ventures where the partners are looking for non-recourse financing (i.e., where the lender looks solely to the venture for repayment and security).
Cash in – External financing cont.

b) There may be a need for JV partner guarantees and remedies for how to deal with guaranty performance failures. A failure to perform a third-party financial guarantee is a very serious event, and jeopardizes the financial viability of the JV. Remedies for a guaranty performance failure should typically be disproportionate and severe, because there was an insolvency event at the JV level and failure of one JV partner to stand behind the guaranty, leaving the other JV partner “holding the bag”:

1. Equity dilution of offending partner.
Cash in – External financing cont.

2. Priority distribution to the non-offending partner, including beyond the amount guaranteed (i.e., making the non-offending partner whole should not be sufficient).

3. Loss of board control or certain veto rights to offending partner (depending upon the circumstances).

4. Potential JV dissolution event.
Cash in – External financing cont.

c) Partner guarantees of external financing can be several or joint and several, with more severe remedies where there is a failure of a joint and several guaranty performance obligation.

d) Great care must be taken in connection with JV partner guarantees of third-party financing. The JV should not be structured in such a way that it would incentivize either JV partner from not performing it's guarantee obligation and walking away.
The Business Plan & Cash in / Cash Out

- Cash in – JV partners

a) Where JV partners are to provide financing, the first question is whether financing would be provided as capital contributions or as debt. Whether it is debt or equity is individual to the JV and the desires of the JV partners, and involves substantial tax and financial reporting issues in each country. Where the JV constitutes a viable, standalone operating business, or where the JV partners must demonstrate certain annual returns, debt is often used so long as the JV is reasonably capitalized.

b) Where debt is used, a decision concerning whether the indebtedness should be secured or unsecured will have to be made. Unsecured debt would give the JV partners the same priority as general creditors. Secured debt would give the JV partners priority over general creditors.
Cash in – JV partners cont.

c) Where the JV is more akin to a “means-to-an-end” venture, equity is often preferred.

d) Remedies for failure to make capital contributions or loans should typically be disproportionate in favor of the non-offending partner as a disincentive, and can include (depending upon the circumstances):

1. Withdraw by the non-offending partner of its proportionate capital contributions.

2. Equity dilution of offending partner.
Cash in – JV partners cont.

3. Right by the non-offending partner to make the capital contribution of the offending partner with a disproportionately larger equity issuance to the non-offending partner.

4. Priority distribution to the non-offending partner, including beyond the amount advanced (i.e., making the non-offending partner whole should not be sufficient).

5. Loss of board control or certain veto rights to offending partner (depending upon the circumstances).

6. Right of non-offending partner to make a (secured) loan to the JV at specified rates with priority distributions.
Cash in – JV partners cont.

7. Right of non-offending partner to make additional capital contributions to the JV (which presents the issue of valuation and dilution of the offending partner).

8. Rights of buyout by the non-offending partner of the offending partner’s equity, or put rights with respect to its equity interests.

The Business Plan & Cash in / Cash Out

- Cash out

a) Where the JV constitutes a viable, standalone operating business or a business that markets into a new geographic market, cash distribution provisions are extremely important and should be set out with specificity.
Cash out cont.

b) Where the JV is more akin to a “means-to-an-end” venture, it is sometimes hard to get the client to focus its attention on cash distribution provisions.

1. Often in these types of JVs, distributions are not contemplated or are scheduled to be made at long intervals (e.g., annually) only if certain hurdles are made. These types of JV entities may be designed to be only modestly profitable, with the real profits and cash coming out of the ancillary agreements (below).

2. In some situations, such as R&D ventures, distributions of cash are not even relevant on an ongoing basis.
Cash out cont.

c) Complex private equity type distribution provisions (with preferred interest waterfall distributions based on rates of return) are rare in strategic commercial JVs, unless one of the partners is primarily a funding source.

d) Distributions allocations typically follow profit allocations (recall that cash does not equal profits). To avoid disputes, distributions should be formulaic. Often, formulaic distributions are based on some form of EBITDA approach and subject to override by the BOD or under circumstances that would not cause cash flow shortages under the then approved Business Plan (which prudently should include 2 or 3 year cash flow and capex forecasts).
Cash out cont.

e) Always be mindful of the “Default Rule.” Each JV has a board of directors, management committee or other body that has managerial authority over the JV. The Default Rule is the result that would occur if the JV partners, through the managing board or otherwise, cannot agree on how to treat the item at issue. Because distributions are almost always included in the veto right of the governance provisions, a failure of the parties to agree on specific distributions means that whatever provisions are set out in the JV agreement will control distributions. For this reason, a required distribution provision that is formulaic is advisable.
Cash out cont.

f) Note that the Default Rule applies to a wide variety of issues in a JV. It is, therefore, important to be comfortable with the consequences of a failure to reach agreement on many critical issues. For example:

1. If the JV partners cannot otherwise agree, periodic cash distributions will be made on a formulaic basis; or

2. If the JV partners cannot otherwise agree, no distribution's will be made.

g) In most JVs, the Board of Directors has significant authority over distributions if and to the extent that cash is otherwise needed under the Business Plan, the capital expenditures plan, or otherwise for working capital purposes.
Governance & Control Issues

- Typical JV governance structure basics

  a) Management is typically responsible for day-to-day operations of a venture company.

  b) A governing board oversees management.

    1. JV partners must determine how the members of the governing board are appointed.

    2. Members of the governing board are typically removed and replaced by the JV partner that appointed them.
Governance Structure Basics cont.

c) JV partners may agree on a list of specified actions of the JV that will require majority board approval.

d) A shorter list of JV actions may require a higher level of board approval (i.e., a level intended to require approval of some or all minority partners’ board representatives).
Governance Structure Basics cont.

e) The JV partners may have voting rights in addition to the board approval rights.

1. If the JV has minority partners, supermajority voting requirements can be used to give minority partners veto rights.

2. If the JV has minority partners, the list of matters requiring partner approval is likely to be shorter than it would be in a 50/50 JV.
Governance Structure Basics cont.

f) Board and partners’ approval rights may overlap. Venture documents do not always clearly indicate if board or partner approval (or both) is required.

g) JV partners should consider limiting the number of matters partners must approve.

   1. Avoids delay.

   2. Fewer opportunities for partners with veto power to extract concessions.
h) JV partners should consider if there is a governance role for:

1. independent directors;

2. board committees; or

3. advisory boards
Governance & Control Issues

- Board members’ fiduciary duties will impact board decisions

  a) Generally, board members have fiduciary obligations to all JV partners, not just the partner who appointed them.

    1. A JV partner may expect its board representatives to act exclusively in the partner’s interest. Unless fiduciary duties are waived, the board must act in the best interest of all JV partners.

  b) Certain issues may be avoided by giving partners direct decision-making authority.
Fiduciary Obligations cont.

c) JV partners should consider whether to waive all fiduciary obligations of the board.

1. Board members must still act in good faith.

2. Limited waivers of certain fiduciary duties may be an option.
Governance & Control Issues

- Like the public company arena, there is intense focus on governance in joint ventures.

a) Governance in public companies is designed to protect a large body of diverse stockholders.

1. A public company’s management and board generally have broad flexibility to operate the public company's business, subject only to fiduciary obligations.
Governance in JVs cont.

b) Applying public company governance principles to joint ventures may not always make sense.

1. Governance in joint ventures is designed to protect a few partners that often have direct board representation and significant voting rights.

2. A joint venture’s scope and management and board flexibility are often carefully defined.
Liability Issues

Potential liability of a JV partner to the venture or the other JV partners

a) When negotiating the terms of the venture documents, JV partners should consider whether they will make representations and warranties about themselves and/or the assets or services they contribute to the venture.

1. Representations and warranties may relate to the JV partner’s ability to enter into and perform its obligations under the venture agreement, and the absence of any conflicting arrangements.

2. Representations and warranties may also relate to the JV partner’s ownership, condition or suitability of assets before they were contributed to the venture.
b) The JV partners should also address whether they will indemnify the venture (or the other JV partners) for losses arising from breaches of their representations and warranties.

c) If JV partners have indemnification obligations, they will face issues similar to those in the M&A context:

1. What is the scope of the representations made? Are the representations subject to materiality and knowledge qualifiers and/or scheduled exceptions?
Potential Liability cont.

2. For how long will the representations and the indemnification obligation survive after the venture is formed?

3. Are there any limits on a JV partner’s indemnification obligations (e.g., caps, baskets, etc.)

4. Does the JV partner have the financial resources to be able to satisfy indemnification claims?

5. Who controls the defense of third party claims, the venture or the indemnifying JV partner?
There are also key differences, as compared to the M&A context, when a JV partner makes representations and provides indemnification in a venture:

1. If a JV partner indemnifies the venture entity, it will make indemnity payments to an entity it jointly owns, not to a third party.

2. Will the indemnification arrangements disturb the ongoing business relationship among the JV partners?

3. What happens to a JV partner’s indemnification obligations when JV partners exit the venture?
e) The JV partners must determine who will be indemnified for losses from breaches of representations and/or legacy liabilities – the venture or the other JV partners?

1. The JV partners should consider whether the venture agreement will prevent both the venture and other JV partners from recovering for the same loss.

f) The JV partners should also address how decisions about indemnification matters will be made by the venture.

1. Can the indemnifying JV partner participate in a decision to pursue an indemnity claim?
Liability Issues

- JV partners are not generally liable for the liabilities of the venture

a) A venture company is typically formed in order to shield the JV partners from venture liabilities.

1. In addition, a JV partner may form a new subsidiary through which it will invest in the venture in order to protect the other assets of the JV partner.
Liabilities of the venture cont.

b) A new venture company may need guarantees from the JV partners to:

1. Obtain third-party financing.
2. Meet demands of counterparties, e.g., landlords.
3. Satisfy requirements of significant venture clients and customers.

c) The JV partners may negotiate for cross-guarantees from their respective parent companies.

1. Such guarantees provide assurance capital contribution obligations will be met.
Allocating Financial & Legal Liabilities

- **Representations and Warranties – Contributed Businesses**
  
a) In circumstances where two or more JV partners are contributing their businesses to the JV, the purchase agreements would contain various representations and warranties about the contributed businesses.

b) Mirror/Mirror. Should each purchase agreement be treated the same way? Probably yes, unless there is good reason for differences (e.g., one business may have multiemployer plan liability issues, where the other does not.)
c) How aggressive should the representations and warranties and related indemnities be?

1. The baseline approach: One approach is to provide that level of representations and warranties and related indemnities that would, in the M&A world, consist of market terms sufficient to justify the contributed business’ valuation to the JV. This is usually a very good starting point. If the Business Plan is the basis for the JV, ideally each contributed business should contain that level of representations and warranties that support (in a broad sense) the valuations derived from the Business Plan. Indemnification by each JV partner directly to the JV in support of the representations and warranties what also logically follow.
Contributed Business cont.

2. The practical: One JV partner’s confidence level in its contributed business or the other’s contributed business may pose substantial issues. This is where good old fashion posturing and negotiations can take over, notwithstanding concerns about supporting the JV’s valuation. Normally, the parties agree to use similar purchase agreements with similar terms and conditions. A JV partner’s risk tolerance or negotiating leverage is individual, so there are no hard and fast rules once the parties depart from market terms.
Contributed Business cont.

d) Who gets to rely upon the representations and warranties? The answer to this question depends upon how the remedies are structured in the indemnification provisions, although in most cases there should be sufficient justification for reliance by both the JV and the other JV partner. A baseline construct would provide that the JV would be the beneficiary of remedies for breach of these representations and warranties. This allows for a very clean, predictable approach. It is, nevertheless, not always the approach followed by the JV partners.

e) Note that with respect to IP assets, different considerations may be appropriate. Some IP assets may be licensed into the JV with appropriate IP licensing issues.
Allocating Financial & Legal Liabilities

- Representations and Warranties – Certain Business Plan Assumptions

a) An extremely important, yet most often neglected or consciously disregarded, need of the JV and the JV partners are representations and warranties by the JV partners of the data underlying the fundamental assumptions set forth in Business Plan.
b) For example, if the JV is a production joint venture, the Business Plan – which determines the JV value, cash flow, profitability, etc., of the JV and upon which the JV partners are relying to commit to the JV – contains information of the JV partners that is vital to support the JV.

1. If the Business Plan calls for projected x, y and z product volumes from the factory, should the JV partners not represent and warrant their historical product volumes? (Note here that exchanging competitor information about customer pricing is almost always not permitted, but information concerning product volumes may be permitted.)
Business Plan Assumptions cont.

2. Even if the JV partners are competitors and use clean teams for due diligence, should not much of the vital non-forward looking and fact-based information provided by one JV partner to the clean team be represented as true and correct?

3. Should historical factory costing be represented by the JV partner who owns the facility? Etc.
Business Plan Assumptions cont.

c) For as important as these matters are to the success of the JV, JV partners are surprisingly shy or resistant about making these types of representations and warranties. Sometimes, it’s simply because they haven’t seen them in the M&A context, which is not a sufficient reason for dismissing them in the JV context. If your client is relying upon, for example, the product volume, product cost and the per unit sales history of the other JV partner, which turns out to be falsely represented in the negotiations, unsupported, or unsustainable, the entire premise for your client’s agreement to enter into the JV may have just evaporated.
Ancillary (Operational Agreements)

- Legs on the JV Stool

  a) Some Ancillary Agreements are so fundamental to the JV that they are like one leg on a three-legged JV stool. (We are disregarding non-critical, replaceable ancillary agreements for this purpose.) Without the theses agreements, the JV would fail. These ancillary agreements (to name only a few) may include:

  1. Supply agreements that supply products from the JV to the JV partners.

  2. Supply agreements that supply components from the JV partners to the JV.
Legs on the JV Stool cont.

3. Management agreements that supply operational management to the JV.

4. IP license agreements that provide key intellectual property rights to the JV and the JV partners.

5. IP development agreements between the JV and the JV partners.

6. Employee leasing agreements that supply a workforce to the JV.

7. Lease agreements that provide critical and unique real property (or mineral rights) to the JV.
b) These are the types of agreements that, if there were a failure (material breach) under the agreements, the JV would likely fail as well. They also present special problems that must be dealt with.
Ancillary (Operational Agreements)

- Attention

  a) Attention to these agreements is as important as attention to the primary joint venture agreement. Their terms derive primarily from the Business Plan. It is especially important not to accept standard, "off-the-shelf" agreements or language. There is usually a considerable amount of whole cloth drafting involved in these provisions and all "boilerplate" provisions must be analyzed to be sure that they integrate well with the primary joint venture document and the Business Plan.
Ancillary (Operational Agreements)

- Breach

a) Remedy provisions for breach under these agreements must knit together with the remedy provisions for breach under the primary joint venture document. In fact, all primary joint venture documents and all material ancillary operational agreements should be analyzed for appropriate remedies in the event of a breach of each (recognizing that a different answer may apply depending on which party to those agreements breaches).

b) This effort can be extremely difficult and result in extensive negotiations. On the other hand, simply allowing one party to these agreements to exercise its common-law right of termination (which may be the default rule) may have a disastrous result to the JV and the JV partners.
c) In essence, a question to be asked, is what circumstances should result in a collapse of the entire JV, rather than money damages, equity dilution or other remedy. That is, when does the house of cards fall? The answer to this question can probably be derived from the Business Plan, in discussion with the business development group and the attorneys on both sides.

d) These remedies should also integrate well with the "exit" provisions for the JV (discussed below). There are no magic formulas here. The terms of each JV stand on their own.
Ancillary (Operational Agreements)

### Special Approval Rights

a) The JV agreement itself should provide that (in most circumstances) the JV partner who is not party to the ancillary agreement should have the exclusive right to act for the JV vis-à-vis the other JV partner in connection with that agreement. This is a succinct yet critical provision. Otherwise, the majority JV partner (if it has management control) could simply block the minority JV partner from taking action (such as, exercising rights of termination, making elections of extension, etc., on behalf of the JV) against the majority JV partner.
Special Approval Rights cont.

b) For example, suppose a JV has a 70% partner and a 30% partner, and each partner has a critical supply agreement with the JV. The 30% JV partner should have the right to step into the shoes of the JV to act for the JV in connection with the supply agreement between the JV and the 70% partner, including making elections, giving notices, making claims for breach of contract and pursuing remedies. Otherwise, the 70% partner could, through its management control of the JV, effectively act on both sides of its supply agreement and block enforcement of non-compliance. Remember that the Default Rule would apply here and, absent a provision like this, may not give the 30% JV partner the right to pursue default remedies against the 70% partner.

c) Material ancillary agreements should also be covered by the restrictions on interested transactions.
Ancillary (Operational Agreements)

- Assignment / Bundled Interests

a) One legitimate concern that each JV partner should have concerning assignment and transferability of JV interests is the potential for a separation of the equity interests in the JV and the contract right under the ancillary agreements. This would be particularly problematic where it might be possible for one JV partner, through a complex of affiliates, to indirectly transfer the beneficial interests of certain agreements to competitors without transferring the equity interest in the JV. (This is usually a problem for large companies with lots of affiliates around the world.)
Assignment / Bundled Interests cont.

b) One way to handle this issue, in addition to inclusion of change of control provisions and anti-assignment provisions, is to provide for the transferability or non-transferability of "Bundled Interests". “Bundled Interests” would include each JV partner's equity interests in the JV and all of it's rights to all material ancillary agreements.
c) Whether or not the JV has ancillary agreements with affiliates of the JV partners in various countries around the world, one could approach the issue of assignability of any particular agreement (including the JV agreement itself) similar to the way the remedies provisions under the various agreements are integrated. In certain JVs, it may simply not make sense for the equity interest in the JV to be separated (directly or indirectly) from the various material ancillary agreements under any circumstances. This can be accomplished by designating the rights under these equity interests and ancillary agreements as being so integral to the JV that they cannot be legally separated. Hence the phrase "Bundled Interests". Anti-assignment provisions would apply to Bundled Interests, and the JV partners would agree not to separate Bundled Interests (outside of a consolidated control group).
Exit & Other Unwind Considerations

- Exit mechanisms include:
  
a) Withdrawal of a JV partner from the venture
b) The sale of the venture company to a third party
c) Buy/sell provisions
d) Put and/or call rights
e) Termination of the venture
Exit & Other Unwind Considerations

- There are several reasons to include exit mechanisms in the venture agreement:
  
  a) To provide an ultimate resolution if deadlocks among the JV partners are unresolvable / to create an incentive to resolve deadlocks.
  
  b) To allow withdrawals by non-defaulting JV partners if another JV partner breaches / to deter breaches of the venture agreement.
Reasons to Exit cont.

c) As an alternative for dealing with a change of control of a JV partner.

d) To provide more certainty to JV partners who joined the venture in order to exit the business conducted by the joint venture in stages.

e) To provide an exit if, after a specified period:

1. Partners no longer believe the venture can fulfill its objectives.

2. Partners want to monetize their investment.
Exit & Other Unwind Considerations

- When negotiating exit provisions, keep in mind:

  a) The venture’s purpose

    1. Was it formed to give JV partners the ability to exit the business of the venture company in stages? If so, a right to initiate a sale of the venture may be an appropriate exit mechanism, but not a call right.
Negotiating Exit Provisions cont.

b) The JV partners’ investment horizons and liquidity needs

c) The JV partners’ respective financial resources

   1. If one JV partner lacks sufficient resources to buy out the other JV partner, call rights or a buy/sell mechanism may not be equitable.

d) The joint venture’s financial resources

   1. Will the venture be able to redeem equity from withdrawing partners?
Negotiating Exit Provisions cont.

e) Applicable regulatory or contractual limits

f) Legal, accounting and contractual consequences if the identity or ownership percentages of the partners changes
Exit & Other Unwind Considerations

- Exit provisions should address:

  a) The consequences of withdrawal under agreements between the withdrawing JV partner and the venture, including agreements such as:

  1. Technology licenses or real property leases.

  2. Commercial contracts such as distribution agreements or service/support agreements.

  3. Guarantees of venture debt or other venture obligations.
Exit Provisions cont.

b) Continuing obligations or rights with respect to confidential information:

1. The withdrawing JV partner’s obligation to return or destroy the venture’s confidential information.

2. The withdrawing JV partner’s ability to disclose or use the venture’s confidential information.
Exit Provisions cont.

c) The survival period of restrictive covenants in the venture agreements, including:

1. Non-competition covenants

2. Non-solicitation covenants
Exit Provisions cont.

d) Any rights of the withdrawing JV partner to continue to participate in the economic returns of the venture.

e) The effect of the withdrawal on any shared asset arrangements between the venture and the withdrawing JV partner.

1. Can the venture continue to use shared assets owned by the withdrawing JV partner?

2. Can the withdrawing JV partner continue to use shared assets owned by the venture?
Considerations for International Joint Ventures

Transforming World Through International Joint Ventures

Artur Kluž, Partner, Metropolitan Capital Solutions
Agenda

- International Joint Ventures – Highlights
- Pros and Cons of Entering in an International Joint Venture
- Case study – Factsheet
- Complexities and Challenges for International Joint Ventures – *Beyond the Deal Structure*
- Conclusion
Since the financial crisis - an emerging trend of companies entering into joint ventures rather than 100% acquisitions, particularly in Central Europe and the Middle East, Africa, Asia Pacific and South America regions.

Innovative cross-border joint venture structures - being used more frequently to achieve strategic objectives, realize value and drive growth.

Companies today - need to innovate and expend and be willing to explore creative new business practices, while at the same time balancing the need to operate and manage risk inherent in the current political, regulatory and financial environments around the world.

Worldwide e-commerce - will grow at a 17.1% three-year annual growth rate and e-commerce joint ventures expected to accelerate globally in 2014 on a global basis to 17.9% from +17.1% in 2013. India (27%), China (14%), and the rest of Asia (29%).

Growth of international joint ventures transactions - reflects the increasing globalization of international business relationships.
International Joint Ventures – Highlights

Recent examples of cross-border joint ventures

Alibaba Group and UCWeb have formed joint venture focusing on mobile search. (April 2014)

Ooredoo and Rocket Internet enter joint venture to develop e-commerce in Asia. (April 2014)

Sony Corp. is joining forces with Shanghai Oriental Pearl Co. and form joint venture to make and sell PlayStations and games in China. (May 2014)

Smile Group has formed a US$100 million joint venture with private investment firm TPG Growth for helping Internet and e-commerce companies build and scale their businesses across emerging markets such as India and Africa. (April 2014)
Pros and Cons of Entering in an International Joint Venture

**Pros**

- International joint ventures allow for **much faster and less costly access to foreign markets** than can be achieved by purchasing an existing company in the jurisdiction or starting a new venture.
- **Global expansion and entry into new markets** - the most successful ground for international joint venture.
- International joint venture alliance indicates how a **domestic firm can benefit** immensely by partnering with a **foreign company** to gain a global presence.
- Allow the partners to **move quickly, cost effectively and with credibility** (provided by the reputation of the resident partner) in the local marketplace.
- Sharing the **cost**, improving the **financial resources**, and **reducing the risk**.
- **Strong local partner** - access to knowledge of the local marketplace, established customer base, market presence, employee base, and political savvy.
- Tool for growth, technology and **know-how**, opportunity to gain new capacity and expertise.
- Take advantage of **complementary lines of business and synergies** that may exist between the two companies.
- Public listed companies – shares price increase effect.

**Cons**

- **Reduced managerial participation** - this can lead to loss of control in the overall operation of the joint venture.
- **Legal disputes** – international structure involves complex legal issues.
- Partners **don’t provide sufficient leadership and support** in the early stages.
- **Cultural differences** between parties from different jurisdictions can lead to significant **misunderstandings and inefficiencies**.
- **Operational problems can limit the effectiveness of the venture** - whether they are result of production issues, strategic differences, management control issues.
- **Lack of trust between** the parties can limit cooperation.
- The parties may not share the **common commercial goals** after all.
- **Decision-making and dispute resolution processes** - can be costly and lengthy.
- **Termination of a joint venture** - time-consuming.
- The joint venture partners will need to be clear about the ‘exit’ strategies.
Case Study – Factsheet

- **AYANA** is one of the most successful, dynamic and innovative e-commerce companies with over $800mn EV, headquartered in Amsterdam, listed on the Deutsche Börse in Frankfurt, employing over 1,000 people and present in 20 countries (Europe, Canada and South America).

- **AYANA’s business model** is based on decreasing costs of delivery of parcels in e-commerce transactions. The Company is planning to use drones and other innovative solutions in the near future.

- The innovative nature of AYANA’s e-commerce solutions was confirmed by numerous global awards.

- **AYANA** is in its very intensive and aggressive global expansion process, planning to enter new markets such as China and US within next 3 years.

- As a part of new global strategy, AYANA is also considering new IPO on NASDAQ within next year.

- **Continental Logistic** is one of the largest over $3bn EV global providers of comprehensive logistics solutions and leader in the Middle East, Africa and South Asia.

- Continental Logistic was established in 1970 and is a publicly traded company on the Hong Kong Stock Exchange and the Dubai Financial Market, employing more than 18,000 people in over 400 locations across 70 countries.

- Continental Logistic’s Board of Directors has recently approved new strategy for years 2014-2016, which will drive company into e-commerce sector and implement growth through acquisitions and joint ventures structures.

- Continental Logistic holds a strong market share in logistic businesses in Middle East, Africa and South Asia.

- E-commerce in Middle East, Africa and South Asia is recognized as the fastest growing sector worldwide.
Case Study – Factsheet

Transaction
- **Type of transaction**: International Joint Venture
- **Sector**: E-commerce and Logistic
- **Regions**: Middle East, Africa and South Asia

Joint Venture
- Board of Directors and Management **after eight months of intensive negotiations** decided to formalise future joint venture cooperation in the **Middle East, Africa and South Asia**.
- The joint venture has been established in **Dubai, UAE**.
- To start the joint venture, **US$50 million in funding** was required. Both Parties provided **initial capital in cash**. The remaining capital was contributed in form of **shareholders’ loans**.
- The Parties established **corporate joint venture** - new corporation that is separate and independent from the co-venturers’ respective businesses.
- Business goal - the joint venture **will transform and revolutionize** Middle East, Africa and South Asia e-commerce sectors.
- Joint venture will provide **new and innovative solution for Continental Logistic’s** e-businesses and consumers.
- The move will support the development of the **rapidly growing e-commerce industry in the Middle East and Africa and South Asia** by providing online businesses, and consumers purchasing online, with an innovative solution.
- Through these new innovative solutions, **e-retailers will be able to send goods ordered online faster** than other markets players and will significantly decrease cost of delivery.
- Parties planning to **use drones and other innovative delivery solutions** in e-commerce sector within next 3 years.
Complexities and Challenges for International Joint Ventures – Beyond the Deal Structure

- Emerging and Growth Markets
- Type of Partner
- Transfer of Shares and Exit
- Dispute and Deadlock
- Guarantee and Indemnity
- Management and Ownership Control
- Foreign Entity and Nominee Shares
- Dividend and Consolidation
- Access to Technology and Know-How
- Restrictive Covenants, Non-Compete Clauses, Market Share
- Jurisdiction and Governing Law

International Joint Venture
### Type of Partner

#### Challenges
- Finding the "right partner" and "establishing mutual trust".
- Public vs. Private.
- Strategic vs. Institutional.
- **Due diligence** should be done.
- You will "live with" your joint venture partner - visit them in their own milieu and see how they behave.
- The best joint ventures partners:
  - *long-term sustainability* of the business.
  - formed by companies that recognize their specific long-term needs.

#### Our case study
- Continental Logistic and AYANA are both public listed companies.
- AYANA is a **mature market** based entity.
- Continental Logistic’s major businesses and asset is located in **emerging markets**.
- AYANA and Continental Logistic both are **strategic joint venture partners**.
- Both Parties’ owners and management executives’ representatives **visited each other** and **saw their milieu and how they behave** several times before any formal arrangement, as well as, representatives of operation, finance, IT, production and R&D departments.
- **Strategic advisory firm** with an international joint ventures transactional expertise were appointed.
# Emerging and Growth Markets

## Challenges

- International joint ventures – often formed when **entering less developed countries**.
- Market access in a **new and heavily regulated jurisdiction** (e.g., Saudi Arabia, China, Russia, African countries).
- Market access in a **regulated industry** (e.g., postal services, aviation, oil and gas).
- Local business and legal environment can **change very quickly; operating and investment risk**, such as:
  - foreign investors protection;
  - political and economic stability;
  - impact of religion and culture;
  - know-how and intellectual property rights protection;
  - security;
  - availability, quality and need for local talent;
  - compensation and benefits, expatriate cost sharing arrangements.

## Our case study

- NewCo JV **formed in Dubai** with business activities in Middle East, Africa and South Asia.
- Our Parties **hired international law firm** with strong presence and expertise in the Middle East, Africa and South Asia, as well as in London and New York.
- Our Parties have made (internally and through external advisors) broad preliminary **new market assessment and potential risk mitigation analysis**.
- **Middle East, Africa and South Asia regions and cultural differences** (e.g., foreign parties to a joint venture will usually need to accommodate a different working week).
Type of Structure

Challenges

- **Local vs. Regional vs. Continental:**
  - location of the joint venture vehicle, the possibility of using different legal vehicles in different jurisdictions.

- **Determine the best JV holding structure:**
  - contractual vs. structural arrangements;
  - the structure should fit with business objective of the participants;
  - risk to investor’s reputation due to lack of control/oversight over partner;
  - consolidation assessment - with near 50%-50% deals;
  - corporate tax upon liquidation/exit.

- Many joint ventures fail due to ineffective **transition from joint venture agreement to real implementation and execution.**
Type of Structure – Our case study

Determine the best joint venture holding structure:

- **JV corporate structure** – two Parties (AYANA and Continental Logistic) created a separate company NewCo JV (Limited Liability Company – LLC) by jointly funding it and managing it;

- this type of JV corporate structure enables Parties to **share risks, rewards and talents** in developing new markets in the Middle East, Africa and South Asia;

- the structure can be used to **similar deals in other regions/markets** according to Business Plan and Strategy.
Jurisdiction and Governing Law

Challenges

- Local jurisdiction vs. Foreign jurisdiction.
- **Laws of the jurisdiction:**
  - where the joint venture will be principally located;
  - commonly chosen to govern the joint venture agreement.
- **Dispute resolution clauses:** in the absence of an effective jurisdiction or arbitration clause THEN rules of private international law apply to determine the correct forum.

Our case study

- Our **NewCo JV Holding** company is located in Dubai, UAE, other business and operating subsidiaries will be established in dedicated countries in the Middle East, Africa and South Asia.
- NewCo JV Holding and Operating company – **UAE law**.
- Subsidiaries of NewCo JV Holding - separate **local jurisdictions**.
- Joint Venture Agreement – **English law**.
- Governing law – **neutral jurisdiction**.
- **Asset protection** and NewCo JV Holding company jurisdiction – local asset vs. International asset.
Restrictive Covenants, Non-Compete Clauses and Market Share

Challenges

- "ALWAYSE WAR"!
- **Restrictive Covenants:**
  - careful consideration needs to be given to the wording.
- **Non-Compete Clauses:**
  - each Party will **not solicit or entice** away any customers, suppliers or employees of the joint venture;
  - **post-termination** non-compete, non-solicitation and confidentiality clauses;
  - **considerable care, scope and duration**.
- **Market Share and Non-Compete Clauses:**
  - **to be enforceable** must be reasonable in scope, duration and geographical extent (local, regional, global);
  - **too extensive** could be held to be anti-competitive, then void and unenforceable – it could lead to penalties and/or other actions.

Our case study

- Relevant Date vs. Restricted Period.
- Restricted Businesses.
- NewCo JV’s Exclusive Cooperating Countries.
- Continental Logistic access to Global Markets /Free Countries vs. AYANA’s markets and protection.
- **Competition Law:** Confidentiality Clauses vs. Restricted Period.
### Challenges

- One party may fear that the other will attempt to **gain access to its know-how, intellectual property, markets data** with the an intention of competing independently (domestic or global markets).

### Our case study

- Access to NewCo JV’s know-how.
- Access to AYANA’s know-how (software, business expertise, technical).
- Access to Continental Logistic’s know – how (local markets’ customers data and expertise).
- Software License Agreement – AYANA vs. NewCo JV’s.
Dividend and Consolidation

**Challenges**

- **Dividend:**
  - no significant limitations on the discretion of the corporate joint venture to distribute dividend;
  - dividend should be paid out of profits, and not out of capital.

- Consolidation vs. public listed and holding company.

- **Voting control:**
  - Party with voting control generally consolidates;
  - minority shareholder with participating and/or **significant veto rights** may prevent consolidation by the majority shareholder;
  - only **substantial** kick-out rights and participating rights.

**Our case study**

- **Dividend:**
  - distributed (on an annual basis);
  - on a pro rata basis by reference to the shareholder proportion held by each shareholder, **ONLY IF** the NewCo JV is able to meet any outstanding obligations to suppliers and other lenders (which may include a Party), as approved by the Board.

- AYANA: public listed company, in aggressive global expansion process and growth capital need – **NEEDS CONSOLIDATION!**

- AYANA holds 49% of NewCo JV’s shares and **1% Nominee Shares** vs. consolidation issue.

- AYANA holds **practical and effective** control over the NewCo JV:
  - indicate and appoint General Manager (run day by day activities and represent the Company);
  - exclusive provider of software to NewCo JV.
### Foreign Entity and Nominee Shares

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<tr>
<th>Challenges</th>
<th>Our case study</th>
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<tr>
<td>- Foreign Participation Rules.</td>
<td>- AYANA – foreign shareholder in NewCo JV Holding – requirements of the UAE Companies Law – one percent (1%) of the NewCo JV’s shares owned by AYANA shall be registered in the name of third local party.</td>
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<td>- Protect the foreign shareholder's position:</td>
<td>- No economic or other beneficial interest in nominee shares for third local party (AYANA).</td>
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<td>- majority of the legal interest to reside with a local shareholder;</td>
<td>- Shares transfer and voting rights restrictions against Continental Logistic (e.g., 75% and 100%)</td>
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<td>- foreign shareholder may only hold 49% of the shares in a company, it could be entitled to 80% of the profits;</td>
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<td>- threshold for passing resolutions at a level higher than the simple majority (e.g., 75%);</td>
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<td>- foreign shareholder controls the day to day running of the business;</td>
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<td>- foreign shareholder has the right to appoint the executive management team, such as the CEO, CFO and COO,</td>
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<td>- the removal of the officers be subject to the consent of both shareholders.</td>
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Management and Ownership Control

Challenges

- **Management vs. Board of Directors vs. Shareholders** – members indication and appointment and where is a day by day management control located?
- Practical and effective control.

Our case study

- **AYANA indicates** General Manager.
- **General Manager** - the power of attorney in the agreed form granted by the Shareholders in favor of the General Manager granting the General Manager the power to **manage the Company**.
- The Parties keep **equal** ownership and profit control over the NewCo JV Holding.
- **Bord of Directors** holds new business and operation long-term control over the NewCo JV Holding.
- **Shareholders** holds a long-term strategic and business control (e.g., country’s business plan and long-term business plan – approvals).
Guarantee and Indemnity

Challenges

- **Holding entity as a guarantor** of shareholders in international joint venture structures.

Our case study

- **Continental Logistic holding company** – guarantor of all obligations under joint venture agreements (Continental Logistic’s SPV – Party of the Joint Venture Agreement).

- **Protection of AYANA** (as a foreign shareholder) from any third parties claims and expenses.

- Special Guarantee and Indemnity **declaration** attached to the joint venture agreement (English Law requirement).
## Dispute and Deadlock

### Challenges

- **Enforcement of any court or arbitral award** in the country in which the **joint venture's assets are situated**.
- **Principal issues**: 1) the choice of governing law; and 2) the forum for dispute resolution.
- Irrespective of the parties – local court will instead **apply its own domestic law** – this is why parties opts for arbitration.
- **Proceedings under local law** will be held in local official language e.g. Arabic.
- **Deadlock**: - chairman or chief executives of the joint venture participants;
  - Russian roulette;
  - Texas shoot-out.

### Our case study

- Dispute Resolution Procedure – **internal mediation process**.
- Parties were unable resolve their disputes then can submit to the **exclusive jurisdiction of the courts in England**.
- **Service Agent** appointed in England.
- **Deadlock** – Board and Shareholders resolutions – 3 times deadlock process.
Transfer of Shares and Exit – *IPO vs. Private M&A*

### Challenges

- **Lack of an exit strategy** – common mistake.
- **Rule:** prohibit the other parties from transferring their shares in the joint venture vehicle to a third party without first obtaining their consent.
- **Exceptions** to the absolute restrictions – parties need flexibility (right of first refusal, tag along, special situations).

### Our case study

- Transfer of Shares – restrictions.
- Right of First Refusal.
- Tag Along.
- AYANA’s future *NASDAQ IPO* and Continental Logistic’s shares valuation – same valuation formula and mechanism as AYANA shares were valuated.
- Exit vs. market share restrictive covenants.
- Protection of AYANA’s global expansion interests.
Conclusion – Key points

- International joint ventures are **efficient and cost effective ways** to enter foreign markets. **Share risks and exploit synergies** with partner companies.

- International joint ventures can provide **access to unique business opportunities and know-how**.

- A **thoughtful structure, long-term goals, careful planning**, and a **willingness to remain flexible** during the existence of the venture are critical to increasing the chances of success.

- **Technology transfer and access to know-how** is one of the most sensitive issues confronting international joint venture managements.

- **Non-compete and market share clauses, dispute resolution, exit and shares transfer mechanisms** should be properly and fairly drafted in the international joint venture agreement.

- International joint venture agreement – must be a „**living” document“ – procedures for changing of the agreement and structure.
THANK YOU