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Good Deals Gone Bad

Joint Venture & Partnership Disputes

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Joint Ventures and Partnerships offer Many Advantages for Business

JVs Drive Business Growth

- CalPERS estimate: More than 1000 JVs with more than $1 Billion in annual revenues or invested capital
- 8 largest publicly listed oil and gas companies and 6 metals and mining majors have more than $500 billion in assets in major JVs.
- Peter Drucker: *Businesses used to grow in one of two ways: from grassroots up or by acquisition. In both cases, the manager had control. Today businesses grow through alliances, all kinds of dangerous liaisons and joint ventures, which, by the way, very few people understand.*

JVs Provide Many Advantages

- Sharing of technology
- Combining resources for large, capital or risk-intensive projects
- Entry into new geographic markets
- Allow company combinations without modifying their own corporate structure and governance
- Greater flexibility for parties to structuring their relationship

Disputes Arise Related to a Range of Topics

- Whether the parties intended to form a joint venture or partnership
- Governance of the venture, and whether one party is making the expected level of contribution
- Ownership of intellectual property created by the joint venture, and the rights of the parties to use intellectual property outside the venture
- Scope of non-compete obligations between the parties

Whether the Parties Intended to Form a Joint Venture

Typical Circumstances

- One party intends a simple contractual relationship (e.g., service provider or financial contributor), while the other party believes (or alleges) that there is a joint venture
- One party believes negotiations are still ongoing, the other party believes (or alleges) that the venture has been formed
- One party believes that the parties' relationship was formalized in a corporate structure with limited liability; the other party believes (or alleges) that the venture or partnership exists beyond the corporate form

Whether the Parties Intended to Form a Joint Venture

General Requirements for Joint Venture

- In most jurisdictions, a joint venture can be established without any specific formal agreement, and can be implied by the facts.
- It is the nature of the enterprise that controls the determination. The factors to consider differ somewhat by jurisdiction, but typically include:
  - Contribution of money, assets, labor or skill by both parties
  - Right to share in the profits
  - Duty to share in the losses of venture
  - Evidence of intent to be associated as joint venturers
  - Joint control or right of control
  - Community of interest in the performance of a common purpose
- Jurisdictions differ on whether each element must be satisfied

Case Study: *Energy Transfer Partners v. Enterprise Products Partners*

Enterprise

- Network of mid-stream oil and gas assets, including pipelines
- Connections with customers

Energy Transfer Partners

- Owned oil pipeline that could be used for portion of desired pipeline route
- Custom software development firm

Double E Pipeline

- Develop a pipeline from Cushing Oklahoma to Gulf Coast
- Use ETP converted oil pipeline for portion of route

Case Study: *Energy Transfer Partners v. Enterprise Products Partners (Cont.)*

- **March – April 2011:** Parties sign Confidentiality Agreement, JV Term Sheet, and Reimbursement Agreement.
- Each agreement contains express language stating that the agreements are not binding, including:
  - "no party hereto will be under any legal obligation of any kind whatsoever with respect to any transaction by virtue of this Agreement or any written or oral expression with respect to such a transaction by any Party or their representatives."
  - "no binding or enforceable obligations shall exist between the parties with respect to the Transaction."
- **End of April, 2011:** Parties announce that they have agreed to form a 50/50 joint venture, named Double E Pipeline.
- **May and June 2011:**
  - Parties establish joint engineering team to develop building plans and solicit bids on project.
  - Parties began marketing to potential clients. Marketing materials state that Enterprise and ETP had formed a joint venture.

Case Study: *Energy Transfer Partners v. Enterprise Products Partners (Cont.)*

- **July 2011:** Parties decide to build new pipeline (rather than repurpose ETP pipeline) due to rising costs of conversion, reducing potential profits.
- **Beginning of August, 2011:** Enterprise approaches Enbridge about pursuing a bigger pipeline.
- **Mid-August:** Double E Pipeline gets commitment from only one shipper at end of open commitment period.
- **Mid-August:** Enterprise informs ETP that Double E Pipeline is not commercially viable.
- **August 19 2011:** Enterprise issues a unilateral press release announcing that it was not moving forward with the project.
- **September 2011**: Enterprise announces joint venture with Enbridge for a pipeline from Cushing to Houston.
- **October 1, 2011:** ETP files suit against Enterprise.

Case Study: *Energy Transfer Partners v. Enterprise Products Partners (Cont.)*

Court Denies Summary Judgment

- Enterprise argues that every written agreement states that the agreements are not binding. Thus, no joint venture could have been formed.
- ETP argues that existence of joint venture is governed by Texas law, which applies a non-exclusive five-factor test as to whether joint venture was formed.
- ETP argues that joint venture formed based on conduct of parties. Agreements – and their conditions precedent – are not relevant.
- Court denies summary judgment to Enterprise.

Jury Finds for ETP and awards $1 B

- Jury found that there was a joint venture between the parties.
- Jury awards ETP $319 million in direct damages.
- Jury awards ETP $595 million in disgorged profits.
- Enterprise seeking post-verdict relief from Court.

Avoiding Disputes Regarding Whether the Parties Formed a Joint Venture

- Parties should continue to be clear about their intentions. If they don't intend to be bound, make that clear, and identify conditions precedent (such as board approval of venture).
- Parties should disclaim intent to form partnership. In many jurisdictions, that may be sufficient to avoid a finding of partnership.
- Parties should waive the right to assert any claim based on the purported existence of a partnership or joint venture.
- Also, parties should disclaim fiduciary obligations to the extent possible (not always possible with respect to some obligations).
- If parties need to market venture before determining whether to form the venture, they should make that clear in documents, so that marketing efforts are not interpreted as intent to form venture.
- Regardless of what agreements are reached, parties should be careful about what they state to third parties. Should avoid stating that parties have formed a joint venture if that is not true.

Governance and Fiduciary Duties

Typical Circumstances

- Parties' business objectives diverge, leading to differing views on the goals for the joint venture and the amount of effort to be focused on the joint venture
- Example: Pharmaceutical JV product may represent a "bridge" product to one partner, but may be a key revenue driver for another partner
- Tensions between partners put pressure on governance provisions, with both parties looking for ways to exert more control over the venture
- Typically, when such disputes arise, parties will turn to background fiduciary duties to "fill the gaps" in any governance provisions
- Competing lines of business
- Corporate opportunities
- Application of business judgment rule (i.e. to whom is the duty owed?)

Avoiding Disputes Regarding Governance and Fiduciary Obligations

- Critical for the parties to explore during negotiations their respective corporate goals for the venture.
- Venture documents should clearly state the extent of each parties' respective obligations. If the documents fail to draw the lines clearly, one party may later resort to background fiduciary duties to imply obligations that the other party may not have anticipated.
- Venture partners should be careful to adhere not only to the letter of the agreement, but to the spirit of the agreement. If one party is seen as unreasonably blocking the goals of the venture, obligations not literally expressed in the agreement may be found through an implied obligation of the duty of care and good faith.
- If the venture no longer makes sense for one partner, evaluate ways to reform or terminate the venture rather than dragging heels on fulfilling its own obligations.

Governance and Fiduciary Duties (cont.)

Parties Obligations

- Starting point for such disputes lies in the governing documents, which set forth the obligations and rights of each party.
- Fiduciary duties exist in order to fill the gaps in the contractual relationship, but they cannot be used to rewrite the terms of that venture.
- Fiduciary obligations include the duty of loyalty.
- Fiduciary obligations also include the duty of care and good faith.

Case Study: *Swatch v. Tiffany*

Swatch

- Manufactures and sells watches

Tiffany

- Brings Tiffany brand and distribution outlets

Tiffany Watch Co.

- Jointly develop, market and sell Tiffany branded watches for $3,500

Case Study: *Swatch v. Tiffany*

- **2007:** Joint venture announced.
- **2011:** Alliance stalls. A Tiffany executive tells Swatch that watches are no longer a priority for Tiffany.
- **2011:** Swatch institutes arbitration proceedings, alleging:
  - Tiffany is blocking the venture
  - Tiffany failing to act quickly or make decisions
  - Tiffany not even displaying the watches at Tiffany's flagship store on Fifth Avenue
  - Tiffany is violating obligations under joint venture agreement and failing to act in good faith
- **December 2013:** Arbitration award in favor of Swatch for $449 million.

Fiduciary Duties in a Limited Liability Company

- Statutory Provisions
  - "Duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." *Delaware Limited Liability Company Act Section 18-1101.*
  - "In any case not provided for in this chapter, the rules of law and equity, ***including the rules of law and equity relating to fiduciary duties*** and the law of merchant shall govern." *Delaware Limited Liability Company Act Section 18-1104.*

Fiduciary Duties in a Limited Liability Company (Cont.)

- Default rule in the LLC context: traditional fiduciary duties apply

> "the LLC Act provides a construct similar to that used in the corporate context. But unlike in the corporate context, the rules of equity apply in the LLC context <u>by statutory mandate</u>, creating an even stronger justification for application of fiduciary duties grounded in equity. . ." *Auriga Capital vs. Gatz Property, 40 A.3d 839 (Del. Ch. 2012).*

Fiduciary Duties in a Limited Liability Company (Cont.)

- Fiduciary duties not explicitly stated in the Limited Liability Company Agreement may apply, but such duties may be altered, eliminated or defined by the Agreement.
- However, if the Agreement does not state that the only duties owed are set forth in Agreement, then the traditional fiduciary duties are not altered.

Fiduciary Duties in a Limited Partnership

- Statutory Provision
  - A general partner's fiduciary duties to a limited partnership "may be expanded or restricted or eliminated by provision in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing." *Delaware Revised Uniform Limited Partnership Act Section 17-1101.*
- Even where a partnership agreement purports to require the partners to act in "good faith," if the partnership agreement definition attempts to eliminate or restrict the implied covenant of good faith and fair dealing, the implied covenant will still be held to apply. *See Gerber v. Enterprise Products Holdings, LLC, 67 A.3d 400.*

Recent Case Law Applying Key Principles

- *Auriga Capital vs. Gatz Properties, 40A.3d 839 (Del. Ch., 2012)*
- *Norton vs. K-Sea Transportation Partners, 67 A.3d 354 (Del. 2013)*
- *Gerber vs. Enterprise Products, 67 A.3d 400 (Del., 2013)*
- *Allen vs. Encore Energy Partners, 72 A.3d 93 (Del., 2013)*

Key Drafting Considerations:

- Safe harbors must expressly eliminate and replace traditional fiduciary duties
- Disclaim duties not stated in agreement
- Expressly address corporate opportunities and competition
- In two party joint ventures:
  - Define (or waive) duties of appointed managers
  - Make clear self-interest rule

Ownership and Use of Intellectual Property

Typical Circumstances

- Disputes between joint venture partners often concern:
  - The rights of each party to control and use intellectual property developed by the joint venture
  - The rights of each party to use its own intellectual property developed outside of the joint venture
- Joint venture parties typically enter into cross-licensing agreements to certain existing intellectual property.
- Jointly-developed IP will usually remain the property of the joint venture, although parties may agree that the property is co-owned by each venture party.
- Disputes arise when the venture terminates, and each party claims the right to the venture's IP.

Case Study: *Foster Consulting v. XL Group*

Foster Consulting

- Consultant to pharmaceutical companies in compliance policies and procedures

XL Group

- Custom software development firm

Joint Venture

- Develop compliance software for the pharmaceutical industry

Case Study: *Foster Consulting v. XL Group*

- **Early 2009**: XL approaches Foster Consulting to form joint venture.
- **March-June 2009:** Parties negotiate terms of joint venture agreement.
- **July 2010:** Foster Consulting became dissatisfied with XL Group's performance and terminated the joint venture.
- Parties disputed who held the rights to the software, and Foster Consulting sued XL Group
  - XL Group claimed that under JV terms, it held the sole rights to the software.
  - Foster Consulting claimed that it held the sole rights to the software on grounds that it was a work made for hire.
  - Foster Consulting also claimed that it was a joint author of the software.
- On motion to dismiss, Court found that the work was not made for hire.
- Court questioned whether Foster Consulting's contributions – forms and processes – would be independently copyrightable. But Court permitted that claim to go forward.

Avoiding Disputes Regarding Intellectual Property Rights

- Licensing agreements for joint ventures should carefully describe the IP that is being contributed to the venture, and specify whether the contribution is exclusive or non-exclusive
- The parties' agreements should cover not just patented or copyrighted assets, but also less tangible IP, including trade secrets and know-how
- Parties should carefully consider the types of IP they will develop within the venture. They must consider the background rules that will apply with respect to that IP
  - Who will be listed as inventors for patents? To whom will patents be assigned?
  - Will the parties be deemed co-authors to any copyrightable work?
  - Which parties have rights to file for trademarks?
  - If trade secrets are licensed into a venture, what is the duration of that license and what trade secrets or know-how are covered?
- If parties intend to vary the rights that would exist within the background rules, they must be explicit in doing so.

Non-Compete Obligations

Typical Circumstances

- Joint Venture parties often may be competitors in the same industry (e.g., pharmaceutical companies or energy companies), or their existing business may compete with the business of the venture.

- Often, one party will identify a corporate opportunity (new drug, corporate acquisition) and the question is whether that opportunity is one that belongs to the venture, or one that the party can itself pursue.

- Resolving this issue frequently turns on the definition of the scope of the joint venture's business, and on any non-compete language in the venture documents.

Case Study: *In re Mobilactive Media*

Terry Bienstock

- Former General Counsel of Comcast
- Brought marketing contacts with media companies in North America

Silverback Media LLC

- Provided technical backbone for interactive participation TV
- Provided end-to-end mobile marketing services

Mobilactive Media

- Company to develop, own and market technology and applications to enable interactive video programming and advertising on all media platforms
- Company will do this in North America

Case Study: *In re Mobilactive Media (cont.)*

- **February 2007:** Parties execute Limited Liability Agreement. It provides:
  - "Business purpose" is to develop, own and market technology and applications to enable interactive video programming and advertising on all media platforms within North America
  - Non-compete provision provides that Mobilactive would be parties' exclusive means of engaging in the "Business," and any new opportunities shall be presented to the Company
  - Silverback had tried to narrow the scope of the venture during negotiations, but Bienstock had refused to narrow it.
- **March and May 2007:** Silverback tried to buy out Bienstock.
- **January - August 2008:** Mobilactive media was retained for only two interactive media campaigns, which both went poorly.
- **June 2007 - July 2010:** Silverback separately (and without notice) acquired five other companies whose businesses overlapped the scope of Mobilactive.
- **July 2009 - March 2010:** Internal email reflects concern about how broad the joint venture is; Silverback tries to restructure Bienstock arrangement. Bienstock sues.
- **January 2013:** Court awards Bienstock $3 million based on lost profits from the venture.

Non-Competition Provisions and Enforcement

- **Key to Success**: Define the scope of the joint venture and parallel the non-compete provisions.
- Even if the parties' joint venture or partnership agreement does not include a non-compete obligation, the law imposes a fiduciary duty of loyalty on venture partners.
- Unless contracted otherwise, non-competition clauses can remain enforceable following a change of control. *Universal Studios Inc. v. Viacom Inc., 705 A.2d 579, 582 (Del. Ch. 1997)*; *In re Mobilactive Media, LLC, 2013 Del. Ch. LEXIS 26 (Del. Ch. Ct. Jan. 25, 2013).*
- Parties need to carefully define the scope of any joint venture. It is far better to address disputes concerning the scope of the venture at the time of formation, rather than leave that scope undefined.
- It is often easier to broaden the scope of a venture to cover additional opportunities than it is to narrow the scope after the parties begin working on the venture.
- If the parties disagree on the scope of the venture, consider limitations based on geography customer market or time.

Non-Competition Provisions

- Watch:
  - Product pipeline/evolution
  - Acquisition/change of control

Non-Competition Provisions and Enforcement (Cont.) - Antitrust Considerations

- In determining whether a non-compete provision in JV Agreement is likely to raise antitrust concerns, the following parameters should be kept in mind:
  - The parties should be able to show that the non-compete is reasonably necessary in order for the parties to have sufficient incentives to invest in the joint venture and make it successful; and
  - The non-compete should be reasonably tailored to the parties' legitimate interests in protecting their investment in the JV in terms of application to products and services, geographic area(s), and length of time, and should not be broader than it needs to be for these purposes.

Exit and Termination

- A. Common Triggers
- B. Exit Mechanisms and Related Issues
- C. Structure Issues: Buy-Out Provisions
- D. Judicial Dissolution

Exit and Termination: Common Triggers

- Achievement of construction, operating, financial or other milestones
- Passage of time
- Breach (materiality plus opportunity to cure)
- Change in control
- Bankruptcy/Insolvency
- Deadlock
- Put/Call

Exit Mechanisms and Related Issues

- Product line sale
- Sale of company (merger or forced drag)
- Buy-out of other partner
  - How to value? (watch independent valuation)
  - Discounts for lack of control or lack of market
  - Discount if breach involved (liquidated damages)
  - How to finance? (watch liquidity advantage)
- Continuation of key support by departing partners
- Dilution of breaching partner

Exit: Common Ways to Structure Buy-Out Provisions

- "**Russian Roulette**." One partner serves notice to the other partner stating the notifying partner's perceived value per share of the JV. The partner receiving the notice must then either sell all of its shares to the other partner at that price per share or purchase all of the other partner's shares at that price.
- "**Texas Shoot-Out**." Each partner submits a sealed bid containing its perceived value per share of the JV. The partner with the higher bid buys the other partner out at the higher bid amount.

Exit: Common Ways to Structure Buy-Out Provisions (Cont.)

- **Dutch Auction.** Each partner submits a sealed bid containing the lowest price per share at which it would sell all of its shares. The partner with the higher price buys the other partner's shares at the lower price submitted.
- **Adjusted Fair Market Value.** An expert or auditor determines the "fair market value" of the price per share. Once determined, the partner triggering the buy-sell provision will either buy the other partner's shares at a set premium or sell its shares to the other partner at an equivalent discount.

Exit: Judicial Dissolution

- A party to a joint venture-LLC cannot seek judicial dissolution simply as a means of freeing itself from what it considers a bad deal, even if the members' relationship had been badly damaged. *Lola Cars Int'l Ltd. v. Krohn Racing, LLC, 2010 Del. Ch. LEXIS 176 (Del. Ch. Aug. 2, 2010).*
- A Delaware court may order judicial dissolution of a joint venture-LLC if it finds that the LLC's exit mechanism is not a "reasonable alternative." *Haley v. Talcott, 864 A.2d 86, 2004 Del. Ch. LEXIS 190, 2004 WL 3029866 (Del. Ch. 2004).*

Dispute Resolution Provisions

- Most partnership and joint venture agreements set forth detailed dispute resolution provisions. Those provisions often include:
  - Escalation provision: Disputes must be escalated within the partner's respective entities, up to the CEOs
  - Arbitration provision: Parties typically prefer arbitration to litigation
  - Choice of law and venue provisions
  - Termination rights provisions
- Goal of dispute resolution provisions is typically to keep the parties working within the joint venture.
  - Deter parties from gaining any advantage from being "first to file"
  - Encourage thorough discussions between the parties
  - Allow disputes to remain confidential for as long as possible

Preparing for a Dispute

- If a dispute is likely, parties should take several steps:
  - Conduct very thorough early case assessment
    - Thorough review of governing documents
    - Evaluate background legal rights
    - Collect contemporaneous evidence of parties' intent when entering the joint venture
    - Interview personnel assigned to the venture about nature of disputes
  - Evaluate parties' termination rights and obligations
    - Disputes will often result in termination, and parties need to consider how they will fare if the venture is terminated
    - Evaluate how termination may affect other parts of company's business

Preparing for a Dispute (cont.)

- Follow dispute resolution provisions to the letter.
- Engage in meaningful efforts to settle the dispute. Arbitrators and fact-finders often take into consideration which party appeared to act in good faith. Don't let your opponent paint you as the bad guy.
- Develop your litigation theme early on. Each party will blame the other regarding why the venture failed. Although this may not seem relevant to the particular issue in dispute, it is important to win the battle of the equities.
- While disputes are being resolved, ensure that any personnel assigned to joint venture adhere meticulously to their obligations. Their conduct will be under the microscope.
- Consider available remedies, including injunctive relief (precluding other party from competing with venture), termination/sales provisions, and damages.