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COMMENT: KEEP YOUR EYES OPEN: AVOIDING UNINTENDED CONSEQUENCES IN JOINT VENTURE RELATIONSHIPS

Jeanne M. Rickert[†]

I am delighted to be a commentator on Stephen Fraidin's remarks¹ because I think he has picked, for the practicing lawyer, the most interesting subject with respect to joint ventures.

Preparing for this and listening to Steve's remarks, I realize how a joint venture lawyer is different. From the beginning of my practice, and certainly, with the more joint ventures I work on, I have learned that the lawyer cannot be confrontational. You absolutely have to understand what the parties are about, what the joint venture is about, and the objectives of the parties – both of them, not just your client.

To my way of thinking, the role of the lawyer is to help the parties understand what the objectives are. The marriage analogy is useful because the parties do need a level of trust and a level of commitment to enter into such a relationship. But, as Steve said, joint ventures end. There are very few joint ventures that keep going forever. Usually the parties come together, each with particular skills and particular resources or assets, and for a limited purpose. Although "strategic alliance" is a more nebulous term, the same thing is true for alliances.

The world around you changes, things move on, new things come to the fore – the Internet shows us that. As a consequence,

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¹ See Stephen Fraidin & Radu Lelutiu, *Strategic Alliances and Corporate Control*, 53 CASE W. RES. L. REV. 865 (2003).

the parties need to understand, very carefully, what their objectives are. Corporate law provides a very useful model in this regard. The courts say to the board of directors and to management: "Within the realm of ordinary operations of your enterprise, you have the benefit of the business judgment rule, and the court will not second guess what you are doing." The lawyer needs to take, I think, much the same attitude. I spend very little time on joint venture negotiations or discussions focusing on what the joint venture is going to do. If the business people don't know how they are going to make it work, how they are going to combine their energies and work towards their business and commercial objectives, there is nothing that I, as a lawyer, can bring to that process.

What I can help them understand is to focus on what they hope to take away from the joint venture. How do they define a successful venture? Or, at what point do they have to say the venture is a failure. Of course, we never call it that. But, the parties need to identify the point where they will both say, "No, we are not going to try to make this work any longer. We are ready to end this – how are we going to get out? What do we want to take away, and what are our objectives in that regard?" This is where a lawyer can help the parties focus their thinking.

The real upside is generally not something for the lawyer to worry as much about. If there is success, the parties will renegotiate. They will find a new deal. They will do the merger or a larger business combination. They will find a new way to keep going if it's hugely successful.

Unfortunately, this is part of what gives lawyers a bad name – you are focusing on the down side. What should happen if the joint venture isn't working? What if something didn't go quite as the parties expected? The lawyer needs to focus the parties on that possibility and on what they can and want to take away if one of these situations occurs. What the parties will take back depends on the joint venture, and it is hard to generalize. However, the solution to this problem for any specific joint venture is usually fairly easy to determine once you understand what each party is bringing to the joint venture and what the joint venture is about.

A second point I want to make today relates to fiduciary duties. This is very much a lawyer's issue, but it is also a very real practical problem. Moreover, the law in this area is wholly inadequate. Steve also alluded to this practical problem: the role of key executives and the board that is running the joint venture. Whether the joint venture is structured as a corporation, a partnership, or an LLC, it will usually have a managing board of some

kind. This is a decision-making structure that is familiar to the business people. They're used to a board. They're used to board meetings. Call it what you will, there will be a board.

Typically, the board members are key executives. These executives are not the "directors" of the businesses that are participating in the enterprise, but they are key, top level executives who understand the objectives of the participants. These individuals are chosen to represent the participants in the joint venture because they understand the strategic direction that the participants are bringing to the venture and where the participants want the venture to go. Often, the key managers of the joint venture are also employed by one of the participants.

These key executives owe fiduciary duties to the participants. If a joint venture participant is a public company, its executives owe fiduciary duties to the shareholders of that enterprise. But, as Steve told us, the law will impose a duty to the new enterprise. In other words, under the law, these executives owe a duty to the joint venture. The duties to the joint venture can clearly conflict with the executive's duty to the enterprise that appointed him to his position within the joint venture. Anyone who is representing a public company going into a joint venture and who does not try to address this conflict of interest is in trouble. I have never had a time when I have proposed to address this issue that the parties on the other side had any disagreement that this issue should be addressed. Whether they were German or American, from New York or Minneapolis, everybody understands this conflict. The problem is also shared by all of the participants and their representatives.

The way it has been addressed in the transactions that I have been involved with is to state expressly in the documents that the representatives are entitled to act in the interest of the party they represent. Typically, shareholders coming together to work out their differences are not subject to fiduciary duties one to the other. The directors and employees owe a duty to the enterprise, but each shareholder is understood to be trying maximize his or her own best interest. So, if you characterize the people on the board as representatives of the owners, you can take away some of the burden of this conflict.²

² The parties should consider a clause like this:

xx. Waiver of Conflict of Interest.

(a) Each [equity owner "EO"] hereby waives, on behalf of itself and the Company [being the Joint Venture], any claim or cause of action against: (i) the other EO and its Affiliates, (ii) any director designated or appointed by or at the direction of the other EO, or (iii) any employee of the other EO or any of its Affiliates made available to the

Now, this hasn't been fully tested, and it will be an interesting area to see developed. But you cannot rely on any existing body of law. There is a model of corporate governance from the U.S. public corporations, which is very well developed in this country. In a public company, the directors are agents of the shareholders. By and large the directors of a public company do not have the greatest economic stake in the enterprise. So, as an agent, the directors owe a duty, above all, to the shareholders. The partnership situation is the fact pattern where the people who have an economic stake are also the decision makers. But, the law's model for partnerships is the "punctilio of honor."³

Company while remaining an employee of such EO or Affiliate (a "*Sec-onded Employee*") for any breach of fiduciary duty to the Company by such EO, Affiliate, director, or Secended Employee as a result of a conflict of interest between the Company and the EO or any of its Affiliates which appointed such director or such Secended Employee.

(b) Each EO acknowledges and agrees that in the event of any such conflict of interest, each such EO, Affiliate, director, or Secended Employee may act in the best interest of the EO or such EO's Affiliate which appointed such director or such Secended Employee. This section entitles an EO and its Affiliates and directors and Secended Employees to prefer the interests of the EO over the interests of the Company or any other EO, but does not permit: (i) action taken solely to harm the Company or another EO, or (ii) any breach of this Agreement or any Transaction Agreement.

(c) No director, employee of the Company, or Secended Employee shall be obligated to reveal confidential or proprietary information belonging to either EO (or to either EO's Affiliates), without the consent of such EO. No director or Secended Employee shall be obligated to recommend or take any action in such Person's position as a director or as a Secended Employee that prefers the interests of the Company over the interests of an EO or any of its Affiliates, and each EO and of the Company hereby waives the fiduciary duty, if any, to such EO or the Company of such Person in the event of any such conflict of interest.

(d) Nothing in this Section is intended to or shall override any obligation of either EO expressly provided for in any other agreement to which the Company and an EO are parties.

³ This is the standard articulated by Judge Cardozo in *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928):

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

Id. at 546. The breadth of Judge Cardozo's language is all the more troubling in light of the fact pattern. Salmon and Meinhard were in a partnership for the term of a lease on a building in New York City. The two had entered into a written partnership agreement shortly after Salmon had leased the building to a third party tenant. The term of the partnership was co-terminous with the term of the existing lease. Salmon was found to have breached his duty to Meinhard because Salmon failed to include Meinhard in the plans made for the property after the lease expired. *Id.* at 545-46. Consequently, joint venture participants should take little comfort from the language "while the enterprise continues," which is apparently limiting. As a planning

Under partnership law, a partner is expected to prefer the interest of the other partner(s) or the enterprise and to give those interests precedence over the partner's own self interest. I submit that that is not what business people expect when they enter a joint venture. I think the people understand that they come together for a purpose, and they hope that purpose will remain a joint purpose and be successful for both of them. Each of them also understands that there are limits to what either of them is prepared to do for the joint venture. Each party has other parts to its business, other obligations to other lines of business, and other markets. Although the joint venture brings the parties together to exploit a particular market, whether it is geographic or by product line, each party has obligations to other parts of its business. Neither party expects that it (or the other party) will take *all* the resources of its enterprise and put all of that into the joint venture. From time to time, each party will need to weigh its options and say: "Does this joint venture justify further investment?, or is it more appropriate for this company to invest in other parts of its enterprise?" So, the business people don't expect to follow the standards the law would impose on partners in a partnership. I think it is important that the lawyers try and address this issue so they don't put key executives in an untenable conflict of interest position.

The final point I want to address today relates to the parties' commitment, which also relates to Steve's last point. Both parties want to have comfort that the other side will remain committed to the joint venture. Each party wants to know that the other participant will bring to the venture its best efforts in the sphere of the joint venture.

The way this is typically addressed, with help from antitrust lawyers, is to describe the sphere of operations for the joint venture. Then the joint venture participants agree that, in the sphere of the venture – whatever that is – their joint venture will be each party's sole and exclusive focus. They will focus their energy for this kind of product, for this geographic market, for whatever the business of their venture is defined to be. They agree, at least for the period they are in the venture, and sometimes for a period after it ends or after one of them exits, that they will not compete with the joint venture. This provides comfort that the parties' best en-

matter, careful lawyers and their clients try to expressly limit the scope of the venture (in time, geography, product line, or otherwise), and try to specifically describe the parties' duties to each other. As a practical matter, if the parties' rights and duties are understood from the outset, the risk of misunderstanding and of litigation are minimized. If it is necessary to present the matter to a tribunal, there is a greater likelihood the decision-maker will reach a result that is consistent with the parties intent.

ergy with respect to this opportunity will be directed to the joint venture.

Steve's last point related to change of control and corporate governance issues. In that context, a non-compete provision presents a terrible problem. Assume your joint venture document says if one party suffers a change in control, the other party has a put or a call. There may be a time period on the put or the call, or it can be optional whether the other party will choose to exercise that right. All of a sudden, there is a change in control, and there is a non-compete. Assume, as would likely be the case in today's marketplace and at other points in time, the typical buyer for another company is in an aligned industry and has a related business. The acquirer sees some synergies or some reason to combine enterprises. So, one of the participants undergoes a change of control, and the buyer is in a related business. At that point, the combined entity on the one side of that joint venture is in violation of the non-compete. There are very few cases that really impinge on what the parties can do in a joint venture, but there are several cases that are truly problematic for interpreting non-competition clauses in joint venture agreements in the context of a broader business combination.⁴ The courts will enjoin a transaction or will

⁴ See *Universal Studios Inc. v. Viacom Inc.*, 705 A.2d 579 (Del. Ch. 1997) (noting that Paramount, through a subsidiary, was a partner in a joint venture (JV) operating a cable network). The Partners had a covenant not to compete with the JV, and the parent had guaranteed the partner's performance. The covenant not to compete and the guaranty expressly bound affiliates. Viacom bought Paramount, and the court held Viacom in violation of non-compete as a result of its interests in other cable networks. The court also held that competition with the JV violated the partner's fiduciary duty of loyalty. *Id.* at 591; see also *Vitalink Pharmacy Services, Inc. v. GranCare, Inc.*, 1997 WL 458494 (Del. Ch. Aug. 7, 1997) (entering a preliminary injunction to stop merger because after merger GranCare would be, indirectly, in business prohibited by non-compete). This non-compete expressly prohibited indirect participation in the restricted business. Although the defendant argued that the corporation bound by the non-compete was not in the restricted business, the proxy statement for merger described defendant as part of an enterprise, and one-third of enterprise value was restricted business. *Id.* at *8-9; see also *Goodman Mfg. Co. L.P. v. Raytheon Co.*, 1999 WL 681382 (S.D.N.Y. Aug. 31, 1999) (noting that Raytheon had entered a non-compete in connection with sale of business). The non-compete at issue restricted a portion of the business Raytheon retained after sale. Subsequently, Raytheon sold the remainder of the business and claimed to be free of the non-compete obligation. The court found that Raytheon voluntarily disabled itself from complying with the non-compete provision, so the plaintiff's claim to enforce the non-compete survived a motion to dismiss. *Id.* at *8; see also *NationsBanc Commercial Corp. v. Chem. Bank*, 1994 WL 9655 (S.D.N.Y. Jan. 13 1994), 1994 WL 62945 (S.D.N.Y. Feb. 18, 1994) (deciding Plaintiff's suit for preliminary injunction claiming defendant's affiliate was engaging in business and that defendant was still subject to non-compete granted to plaintiff when it bought similar business from defendant). In the first opinion, plaintiff's case survived defendant's motion to dismiss. 1994 WL 9655 at *3-4. In the second opinion, plaintiff lost the preliminary injunction because the court narrowly construed key clause of non-compete to bind only seller and held that the clause did not reach seller and affiliates. 1994 WL 62945 at *3-5.

certainly find damages in the face of competition in violation of the joint venture covenants.

So, another key issue for the board of the company thinking about a joint venture, and for the lawyer advising a participant, is to understand how a non-compete may come into play in the context of a change of corporate control. Even if the joint venture is not potentially material in the context of a strategic transaction, if there is a third party with a right to enforce a non-compete, it will create a level of uncertainty and a potential for a discount on the value that the company can command in the marketplace. This is something that lawyers and other advisors need to watch. The board needs to consider this when asked to approve a joint venture transaction. Similarly, the lawyer needs to focus the client on this issue when structuring a joint venture.

In conclusion, let me say that for a deal lawyer, joint ventures are the most fun. All participants, the lawyers and the business people, are in a cooperative spirit. They are very creative as you work to determine a structure that will let the parties work together to create or grow a business. Each presents an exciting opportunity, and I enjoy working on them.

