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M&A NOTES

March 2007

SOME ISSUES TO CONSIDER WHEN SELLING A JOINT VENTURE

Joint ventures are common in a number of industries, including the chemicals, pharmaceuticals and automotive industries. Parties (often competitors) form joint ventures for a number of reasons, including because they allow parties to:

- Share relevant expertise and experience
- Reduce their economic exposure to a particular business or product line by sharing research and development, distribution and other costs
- Take advantage of economies of scale and greater, combined market power
- Gain access to geographic markets that would be uneconomic to service on a separate basis

However, joint ventures frequently run into trouble. This often occurs when the owners' interests diverge, which may happen for a number of reasons, including:

- Diverging corporate strategies or focus
- Loss of interest in the joint venture's business or product lines by one or both parties
- Increased interest in the business or product lines of the joint venture by one or both parties, coupled with a desire to pursue the market alone
- Increased IRR targets

Even if the owners' interests do not diverge, because joint ventures are often established in consolidating industries or to hold shrinking businesses or product lines, they often run into financial difficulties. In addition, joint ventures often have complex corporate governance structures (often with various super-majority or negative control rights) that can make efficient decision-making difficult.

Problems with joint ventures often result in the owners' desire to sell or terminate the joint venture. This article discusses some issues that joint venture owners and their counsel should consider when contemplating a sale of a joint venture.

Reach Understanding as to Transaction Timing

If the owners decide to explore a sale of the joint venture, they should reach a general understanding at the beginning of the process with respect to the transaction timeline. Specifically, they should determine whether there are any specific timing issues for either owner. For example, the owners should determine whether there are any internal issues at either owner that could affect the transaction timeline. These issues might include:

- Other pending or contemplated transactions
- Limitations on internal resources
- Internal budget or economic targets
- Internal deadlines for corporate strategic goals of which the sale of the joint venture is a part
- An internal approval process

Resolve Legal Counsel Issues Upfront

Sales of joint ventures can present tricky issues regarding legal counsel, other advisors and potential or actual conflicts. Each owner will presumably have its own counsel, but the owners should consider whether the joint venture entity itself should be represented by separate counsel. Separate joint venture counsel may be helpful or even necessary in certain situations, for example:

- If the owners do not get along, in which case separate joint venture counsel may serve a useful role as an "honest broker" between the two owners in connection with a sale
- If the transaction is structured as an asset sale
- If there are material issues relating to the management of the joint venture arising out of the sale
- To assist the joint venture's in-house counsel in facilitating due diligence, reviewing the sale agreement's representations and warranties and schedules and obtaining any consents, approvals and waivers necessary for the transaction

The owners should determine at the outset of the transaction whose counsel will have primary responsibility for preparing the legal documentation, negotiating the sale and advising the owners with respect to and obtaining required regulatory approvals. In making these determinations, the owners should consider whether it makes sense to share legal expenses and, if so, how they should be shared. The owners should also confirm at the beginning of the transaction that there are no conflicts of interest among any of the lawyers representing the owners or the joint venture itself. In addition, assuming that a financial advisor will be retained to handle the sale, the owners should determine at the outset which party (the owners or the joint venture itself) should retain the advisor.

Agree Upfront Upon Fundamental Acceptable and Unacceptable Deal Terms

The owners should agree upfront on fundamental acceptable and unacceptable deal terms. Most importantly, the owners should agree upon the minimum price at which they would be willing to sell the joint venture so that if the sale process results in a lower-than-expected sale price, the owners will have the same expectations as to whether the price is adequate.

To the greatest extent possible, the owners should identify other deal terms that they consider essential or unacceptable so that there will be no misunderstanding between the owners if the buyer asks for changes to key deal terms or the deal structure itself. For example, the owners should initially determine their positions on the following issues:

- Whether they would be willing to convert from an equity sale to an asset sale and, if so, whether they would be willing to retain certain liabilities and, if so, how those liabilities should be allocated between the owners
- Whether they would accept any consideration other than cash (e.g., a note or stock of the acquiror) or an earnout provision
- What indemnity obligations they are willing to accept
    - Possible significant indemnity obligations ` include those for breaches of representations and warranties, or direct indemnity obligations, regarding environmental, litigation and intellectual property matters
    - The owners should determine other material terms of the indemnity, including whether there will be a cap on the owners' liability under the indemnity and, if so, how much it should be, and the survival period for the representations and warranties, including whether any of the indemnity obligations will be subject to a "sunset" provision providing for

the gradual reduction and eventual expiration of those obligations

- Whether they would accept a purchase price hold back or an escrow
- Whether they would accept certain restrictions on their right to compete with the joint venture and, if so, the geographic scope, duration and other material terms of such a restriction
- Allocation of the purchase price among the sold assets for tax purposes

Determine How Indemnity Obligations Will Be Allocated Between Owners

The owners should determine how indemnity obligations to the buyer will be allocated between themselves. For example, the owners should consider whether:

- Each owner should be 100% liable for losses arising out of assets (particularly plants and facilities) contributed by the owner to the joint venture
- Each owner should be 50% liable for losses arising out of the actions of the joint venture
- Indemnity obligations that arise from a problem -- particularly an environmental problem caused by release of a hazardous substance or other environmental contamination -- that began before a parcel of real property, a plant or another asset was contributed to the joint venture but continued during the joint venture's existence, should be allocated 100% to the contributing owner or allocated between the owners based on the amount of damage caused pre- and post-contribution

Even if the owners will be jointly and severally liable for some or all of the indemnity obligations vis-à-vis the buyer pursuant to the sale agreement, the owners can agree upon a different allocation of liability between themselves in a separate agreement.

Beware of Joint Venture Management Bias

Members of the joint venture management will likely have considerable influence over the sale process due to their role in the due diligence process and the preparation of financial projections for the joint venture and schedules to the sale agreement. Management will likely have a view with respect to the fundamental question of whether the joint venture should be sold at all and, if so, whom the buyer should be. For example, management may prefer a private equity buyer over a strategic buyer because the private equity buyer will more likely need to retain most or all senior management members and/or may offer management members more generous compensation arrangements (particularly equity incentive arrangements) than a strategic buyer.

Owners may seek to counteract the biased role of management in the sale process by assuming a more active role than usual during the due diligence process, including attending all management presentations. To the extent practicable, owners should undertake an independent review of any projections prepared by management. Owners should also consider offering management a "success" bonus payable upon the closing of the sale of the joint venture and based on the sale price.

Determine Post-Sale Relationship Between Owners

Owners should determine the material terms of their relationship following the sale of the joint venture. For example, joint venture owners should determine their post-sale relationship with respect to the follow matters:

- The handling of all indemnity claims asserted by the buyer, including (i) as discussed above, the allocation of indemnity obligations between the owners and (ii) the process for resolving disputes between the owners regarding such indemnity claims, including, with respect to a particular indemnity claim:
    - Whether to accept or reject the claim
    - Whether to assume the defense of the claim
    - Whether to settle the claim and, if so, on what terms
- The handling of any litigation actions commenced by third parties (other than the buyer) arising out of the joint venture's operations, whether those actions are commenced before or after the closing
- Cross-indemnity arrangements with respect to post-closing claims asserted by third parties (other than the buyer) arising out of assets contributed by each owner to the joint venture and actions taken by the joint venture during its existence
- Rights with respect to intellectual property contributed by each owner to the joint venture and intellectual property developed by the joint venture during its existence

In addition, the owners should determine whether it makes sense to terminate the joint venture agreement, amend (or amend and restate) the agreement or simply keep the agreement in place. If the sale is a sale of all or substantially all the assets of the joint venture, the owners should determine whether it makes sense to liquidate the entity and return any retained assets and the related liabilities to the contributing owner.

Conclusion

The decision to sell a joint venture often raises a number of issues between the owners. This article has identified many of the most significant issues that might arise between the owners during the sale process. The owners should seek to address these issues at the outset of the sale process or at least determine that, in the context of their particular joint venture or sale, the issues are not likely to be problematic. Addressing these issues upfront can avoid disagreements and misunderstandings between the owners and increase the chances of a successful sale of the joint venture.

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