Joint Ventures, Joint Development Agreements, Strategic Alliances

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Definitions

- **Joint venture:**
  - –independent business entities
  - –getting together for a common commercial purpose of defined scope and duration
  - –by contract or in the form of a new business entity
  - –pool resources and share risks, rewards, and control
  - –can take a variety of forms – no “standard deal”
  - *–joint development program, contract development, strategic alliance*

What is contributed?

- Intellectual property (patents, copyright, trade secrets, trademark) – may be too complex, difficult or risky to develop on your own
  - Background IP
  - Foreground IP
- Capital
- Testing capability and access to technical expertise
- “Built in” end customer or purchaser
- Manufacturing capacity
- Sales and distribution networks
- Possibly, products outside of the core business area

Stages

- Formation
  - who contributes what
  - start with NDA and then non binding term sheet
- Operation
  -split of profits and IP
- Winding down
  -by agreement
  -bankruptcy (snapshot license)
  -breach of agreements
  -merger and acquisition events
  -wind down operations but continue as IP holding company

Preliminary Questions

- Why do you want to form a joint venture?
- What outcomes do you envision from the joint venture?
- Are there other ways of achieving these goals?
- What makes the other party an attractive joint venturer?
- Are your goals compatible with those of your joint venture partners?
- Are you and your joint venture partners a good match?
  - Business culture
  - Background
  - Experience
  - Organizational values

Contractual Joint Ventures

- Attributes
  - Joint venturers establish and form the joint venture through a contractual agreement
  - No separate legal entity is created
- Why use
  - Preferred when the collaboration between the joint venturers is expected to be of narrow scope and finite duration
  - Best when the parties' business or technology sphere are distinct enough that they are not competitors of one another nor likely to become competitors in the future
- Legal consequences
  - Parties have only limited fiduciary duties to each other
  - Tax issues are usually simplified
  - IP ownership can be more ambiguous if not adequately addressed in advance
- "Joint Development Agreement" – common for early stage tech companies to enter into JDA with large company

Entity Joint Ventures

- Attributes
  - Joint venturers establish a separate jointly owned business entity (such as an LLC or a corporation)
- Why use
  - Preferred when the collaboration between the joint venturers is expected to be multi-faceted and continuing over the long-term
  - Often used when the parties anticipate developing completely new product lines or commercializing new markets
- Legal consequences
  - Parties have a great deal of freedom to limit their exposure to liability or to engage in tax planning by choosing the entity's form
  - IP ownership is simplified since the entity can own IP rights and license them back to the joint venturers

Contractual followed by Entity

- **The choice of joint venture type is not fixed**
  - Two-Stage Model
    - First stage is a contractual joint venture
    - Second stage is the creation of a joint venture entity
    - More complex and less commonly encountered
    - Useful when the joint venturers want a limited initial collaboration to determine the viability of continuing the joint venture as a longer-term, freestanding entity
      - Example: Stage one is to determine the technical and commercial viability of a proposed new product; if that viability is demonstrated, the parties will form a separate entity to bring the new product to market in stage two
      - Allows the parties to set tech, business, or financial benchmarks upon which the formation of the new entity will be conditioned

Without a Written Agreement

- Suppose that two parties collaborate on technology development absent an agreement regarding IP rights. What result?
  - **Patent:** Any person who contributed to the conception of one claim is a joint owner of the patent
    - Doesn’t require the joint owners to physically work together or to work simultaneously
    - Doesn’t even require a general intention to jointly invent
  - **Copyright:** Similar to the patent scenario
    - Like patents, doesn’t require the authors to work together or simultaneously
    - Joint ownership will result only if the creators intend to jointly author the work and their contributions must be “inseparable or interdependent.”

Without a Written Agreement

- Therefore, collaboration without an agreement regarding IP rights tends to create scenarios of joint ownership
- Parties can also agree to jointly own IP
- Joint ownership sounds like a fair outcome, but it is fraught with peril

Patent Joint Ownership

- Patents
  - Each joint owner can freely practice and can (nonexclusively) license the patent to a third party (including one of the other joint owners' competitors)
  - No duty to share profits with the other joint owners
  - A suit for infringement can typically only proceed if all joint owners participate in the suit
    - Any joint owner can cut off the infringement action by granting a license to the alleged infringer
  - Astute would-be licensee can play the joint owners off one another to get the best deal

Copyright Joint Ownership

- Copyright
  - Each copyright joint owner can freely license the work without consultation with or consent from the other owners
  - Unlike the case with patents, joint owners have a duty to share profits from the copyright with other owners ("duty to account")
  - A suit for infringement does not require all parties to join
    - Nevertheless, the court can require it if it chooses
    - A court will also permit intervention by anyone with an interest in the copyright

International Joint Ownership

- If you plan to commercialize your jointly developed technology in other countries, you face different laws (but similarly unsynchronized systems for different kinds of IP!) that must be accounted for
- Choice of law provisions in agreements that indicate US law will apply will not override the default rules of another country with respect to enforcement and exploitation of jointly owned IP

Possible IP Allocation for a Contractual Joint Venture

When Created	What		Who Developed	Ownership	Licenses
Prior to Joint Venture	Preexisting *Background* IP		Individually Developed	Developing joint venturer	Nonexclusive to the other joint venturer(s) within the joint venture field of use
While Joint Venture is in Place	New *Background* IP		Individually Developed	Developing joint venturer	Nonexclusive to the other joint venturer(s) within the joint venture field of use
	Foreground IP	Derivative IP wholly derived from only one joint venturer's Background IP	Individually or Jointly Developed	Whichever joint venturer owns the underlying Background IP	Nonexclusive license to other joint venturer(s). Possible field-of-use limited.
		Nonderivative Any other Foreground IP	Individually or Jointly Developed	One joint venturer only: to be negotiated in advance. Could be "blanket" allocation of ownership (i.e., always to one joint venturer) or by pre-defined area of technology. Joint ownership could be problematic	Exclusive license to other joint venturer(s) in agreed field of use

Possible IP Allocation for an Entity Joint Venture (NewCo)

When Created	What		Who	Ownership	Licenses
Prior to Joint Venture	Preexisting *Background* IP		Individually Developed	Developing joint venturer	Exclusive or nonexclusive for NewCo in field of use
				OR ---------------	--------------------
				NewCo	Nonexclusive grantback outside NewCo's field of use
While Joint Venture is in Place (NewCo)	New *Background* IP		Individually Developed	Developing joint venturer	Exclusive for NewCo in field of use to prevent joint venturers from competing with the joint venture; could be nonexclusive
				OR ---------------	--------------------
				NewCo	Exclusive or nonexclusive grantback outside NewCo's field of use
	Foreground IP	Derivative IP *completely derived from only one joint venturer's Background IP.*	Individual Joint Venturer, Multiple Joint Venturers, or NewCo	Whichever joint venturer owns the underlying background IP.	Nonexclusive to NewCo in field of use
				NewCo	Exclusive to joint venturer who owns the underlying IP outside NewCo's field of use, possibly with further restrictions
		Nonderivative *Any other Foreground IP*	Individual Joint Venturer, Multiple Joint Venturers, or NewCo	NewCo	Exclusive or nonexclusive to joint venturer(s) in defined field(s) of use; could be royalty-free or royalty-bearing

Your IP and Your Partners' Employees

- Not only do joint venturers have to worry about third parties gaining access to proprietary information; they also need to think about their joint venture partners and what employees may be able to do with that information
- The information the employees learn cannot be erased at the end of the joint venture. Two potential hazards result from this:
  1. An employee may leave your joint venture partner for a new position with one of your competitors
     - Especially problematic if your joint venture partner doesn't have a non-disclosure agreement with the employee
  2. Your joint venture partner may form a joint development relationship with one of your competitors

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Your IP and Your Partners' Employees

- Fortunately, by planning ahead, some of these risks can be minimized
  - Joint venture partner agrees to limit the type of future work they assign to their employees who were exposed to your proprietary information, for a limited time
    - In particular, have these employees excluded from working on other joint ventures that your partner might form in the future with your competitors
  - Joint venture partner agrees to have a written confidentiality agreement with its employees naming you as a third-party beneficiary
    - As a third-party beneficiary, you will be entitled to enforce the confidentiality agreement yourself, without having to rely on your partner filing a lawsuit

Questions

- Is your interest in the venture/alliance primarily strategic or financial in nature?
- What consequences would stem from a sale of your interests in the venture/alliance?
- Why does it make sense for you to partner on this project rather than go it alone?
- What opportunities will you forgo by entering into the venture/alliance?
- What is the scope of the noncompetition and exclusivity provisions that are envisioned?

Questions

- What are the strengths that each party brings to the table?
- What are the parties' bargaining powers, both up front and over time?
- How much money do you wish to invest in the venture, both up front and over time?
- What are the expected exit strategies and do all parties have a shared view of the likely exit scenarios?
- Have you adequately considered all that could go wrong with the venture/alliance and how to adequately protect its interests in such various downside scenarios?

Structuring the Deal

- What will the governance structure be?
- What assets will be conveyed to the venture and by whom?
- What will the economic rights of the parties be?
- What is the ideal structure from a tax perspective?
- What corporate approvals are required? Is shareholder approval needed?
- What regulatory filings are needed? Is a Hart-Scott-Rodino or foreign antitrust filing required? Are there any significant anticompetitive consequences to the venture?
- Are any third-party consents needed?
- Has due diligence been completed? What does it reveal?
- What timeframe is desired for completing the deal? What intermediate benchmarks/deadlines exist?

Forms of Entity Joint Ventures

TYPES OF BUSINESS ENTITIES

- The oldest forms are partnerships and corporations (or more specifically, C corporations)
- Partnerships arise when two or more persons or entities join to run a business together and split profits. There is no tax at the partnership level (what is called "pass-through tax treatment") and *partners are fully liable for all claims against the partnership*
- C Corporations offer limited liability, but it comes at price: profits are taxed first at the corporation level and then again as an individual's income when paid out as a dividend

Forms of Entity Joint Ventures

- The S corporation and the LLC were created to combine the best features of each of these two older forms. S corporations feature the limited liability of C corporations with the pass-through tax treatment feature of partnerships. However, S corporations face strict limitations on who and how many can be shareholders. The shareholders cannot number more than 100 and, with the exception of certain trusts and tax-exempt organizations, must be natural persons who are U.S. citizens or residents. Furthermore, only one class of stock is allowed, although differences in voting rights are permitted.

- Finally, the newest form is the limited liability company (LLC). Like the S corporation, it also combines limited liability with pass-through tax treatment. Unlike the S corporation, the LLC is exceptionally flexible with respect to who and how many members (the LLC analogue to the S corporation's shareholder) may have. In particular, there is no upper limit to the number of members, all types of entities may be members, and different classes of ownership are permitted.

Joint Venture Form and Tax Treatment

- One principal consideration in choosing between a contract-based joint venture and an entity-based one (including which kind of entity) is the tax treatment associated with the choice.
- It is important to keep in mind that the IRS looks to the functional realities of the venture and not merely the legal designations that the venturers have used.
  - For instance, a partnership can be formed simply by agreeing to go into business with another and splitting the profits; an explicit choice of the partnership form isn't always required.
  - Consequently, the IRS has regulations that allow them to recharacterize some contractual joint ventures as partnerships if they are too close in function to a partnership.

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Joint Venture Form and Tax Treatment

- On the other hand, the IRS gives businesses a great deal of freedom under its “check the box” regulations.
- Business entities composed of two or more members and which are not organized as corporations under state and federal law may choose to be taxed as a partnership or as a corporation.
  - Default rules govern entities that do not file a “check the box” election. Typically, the rules classify them as partnerships.
  - Once an election has been made, it cannot be changed for five years---unless there is a more than 50% change in ownership
- *Note:* This only pertains to federal tax. State taxation and liability issues are not altered by this system.

Joint Venture Form and Liability Issues

- A second key consideration in choosing the joint venture form is exposure to liability.
  - As mentioned, one of the most desirable features of corporations (both C and S) are their limited liability. In general, shareholders stand to lose only as much as they have invested
  - Partners, on the other hand, face unlimited personal liability for claims against the partnership
  - A limited liability company, as its name indicates, shares the limited liability feature of corporations
  - Contract-based joint venture parties may face liability from activities undertaken in pursuance of the joint venture

Joint Venture Form and Access to Capital

- Venture Capital – while LLCs are attractive because they feature limited liability and pass-through tax treatment, most venture capital firms will not invest in an LLC
- IPO – if the joint venture were to go public, it would need to be converted from an LLC to a C corporation or at least elect to be taxed as a C corporation

Joint Venture Exit Strategies

- Merger or Acquisition of Joint Venture

  – licensed IP should be freely transferable upon change in control; BUT minority contributor to JV may insist that some IP not transferable to a competitor of the minority contributor
- Dissolution of Joint Venture

  –protect member's right to use vs. prohibiting member's right to use

  – many of the same considerations that apply to apportioning IP rights during the JV apply to apportioning IP rights at its termination (in particular, avoidance of joint ownership)

  – prohibitions or limitations on the members' rights to IP after dissolution can serve to discourage prematurely dissolving the joint venture

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Joint Venture Exit Strategies

- Bankruptcy

  – clauses that say a license terminates in bankruptcy generally unenforceable; better to terminate based on other factors – inability to pay bills, etc.

  – bankruptcy courts have broad powers to authorize assignments or rejection of the bankrupt's contract; in the joint development context, this has two consequences:

- to protect the members, ensure that the IP they license to the JV cannot be assigned away to a competitor by emphasizing the importance of the identities of the parties to the licensing transaction
- to protect the JV, ensure that the IP licensed to it meets 11 U.S.C. § 365(n), a provision of the Bankruptcy Code that restrains the court from approving IP license termination

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Distributorships & Sales Representatives

- *Distributors* — Purchase merchandise from manufacturers at a discount (typically larger than the value of a sales commission), profit is made from selling the items at a markup.

- *Sales representatives* — Solicit offers to purchase from consumers, relay these to manufacturers who fill the order, profit is made by earning a commission on sales they procure.

Distributorships & Sales Representatives

In other words, there are two characteristics that distinguish these roles:

1. *Who owns the merchandise?* — Distributors purchase the goods and are responsible for storing, protecting, and selling them once they have ownership. Sales reps ordinarily do not have these obligations.
2. *Who bears the risk?* — Distributors bear the risk of carrying inventory for which there is no demand as well as the risk of a defaulting purchaser. Sales reps do not, although the sales representative agreement can specify that no commissions will be due when the customer fails to pay.

Distributorships & Sales Representatives

Q: What factors might manufacturers consider when deciding to use a distributor or a sales representative?

A: There are two key considerations that enter into the decision: credit risk and control.

Distributorships & Sales Representatives

Credit risk

Local distributors may have better information about the creditworthiness of local potential buyers. Where the typical potential buyer is a small unknown business, a manufacturer may find offloading the credit risk to a distributor attractive

When the typical potential buyer is large, well-known, and well-capitalized, using a sales representative will be a less costly way doing business

Distributorships & Sales Representatives

Control

Unlike distributors, sales reps only solicit offers and own no merchandise. Therefore, the manufacturer retains control over:

order acceptance: sales reps cannot accept orders, they only relay them to the manufacturer

price: the sales rep does not own and resell the merchandise as distributors do, the manufacturer keeps absolute control over price

customer relationship: manufacturers typically work more closely with customers when there is no distributor as a middleman

Distributorships & Sales Representatives

Exclusive versus Non-Exclusive Arrangements

Procuring Cause Rule (applicable to sales reps only)

Extremely important to specify that commissions are payable only on sales *procured* by the sales rep (indeed, the agreement should use that very word). Otherwise you might have to pay a commission to a sales rep who had nothing to do with the sale!

Toll Manufacturing

- **Toll manufacturing,** also known as *toll processing, tolling, toll conversion,* or *custom manufacturing,* can be defined as performing a service on a customer's raw material or product, for a fee (toll). Toll manufacturers provide a manufacturing/processing service for other companies and receive a volume-based fee
- Traditionally used for prototypes, marketing studies, and small-scale specialty products, and is a means to expedite manufacturing and marketing
- Tolling also reduces capital expenditures and the need to hire and train temporary personnel

Toll Manufacturing

- Toll manufacturing agreements demonstrate a large variety of terms. In many ways, the agreement is limited only by what one is capable of negotiating. The relationship can be continuing or on an as-needed basis. The toll manufacturer and its client can cooperate intensively on the fabrication process or remain quite distant
- Given the open-ended nature of the toll manufacturing field, it is important to have considered all possible terms and conditions and to know where you need to be insistent and where you can be flexible
  - In addition to the obvious terms of cost, volume, and turn-around time, be sure you know what you need in terms of confidentiality, meeting regulatory requirements, quality control protocols, distribution/shipping costs, risk management and beyond

Toll Manufacturing

Some of these additional considerations include:

- **Economics.** Lower operating cost must be weighed against the extra cost of negotiating toll agreement and monitoring performance
- **Confidentiality.** Ensuring that intellectual property and commercial secrecy are not compromised is particularly critical. If you and the toll manufacturer jointly develop a product or process as a result of your relationship, how will you split that reward?
- **Government regulations**. Dealing with regulations, particularly those of distant states or foreign nations, can involve uncertainty, red tape, and delays that can be costly
- **Time zone difference.** Consider the implications in terms of the on-call availability of personnel. Consultation with an expert in the home office may be required outside that person's normal working hours. An alternative is to temporarily relocate a technical representative at the facility
- **Manufacturing practices.** This is particularly important in industries where adherence to current good manufacturing practices (cGMPs) is essential.
- **Conflicts of interest.** Potential conflicts of interest may arise if the toller is an ex-employee of a competitor or of your own company

Contracts and the 5Ws

- One of the most important functions of a written contract is to document the intentions and expectations of the parties
- Remember the 5Ws of telling a story—contracts are no different
  - Who are the parties to the contract? Who are any third parties that will play a role in the contracted relationship?
  - What do the parties promise to do for each other? What conditions will make these promises come due or excuse them?
  - When are the obligations to be performed? When will the contract expire?
  - Where is the contract applicable? What territory is envisioned? Which jurisdiction's laws will govern?
  - Why is the contract being created? Use a recitals section to contextualize the contract.
  - How much is at stake? Not just dollars, but also volume of merchandise or numbers of licensed users.

“Integration” or “Merger” Clause

- Paragraph that states the written contract is the entire agreement between the parties and that there have been no other representations or promises made

- Typically appears at the end of the contract

- The use of an integration or merger clause means that any prior promises made by the parties (whether oral or written) would not usually be enforceable unless there has been fraud

- Consequently, the parties should not rely on any “side promises.” If they’re integral to the deal … **“Get it in a signed writing.”**

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