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Joint Ventures in Information Technology: Stone Soup Revisited

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Most of us are familiar with the "Stone Soup" story, read to us as children, about a traveler (a rabbit, according to my daughter) who comes into a town hungry, without food and carrying only a kettle. The rabbit finds many wary townspeople, each with a small amount of food, but no one willing to share their meager portions. The rabbit then heats some water in the kettle, puts in a rock and begins making "Stone Soup." The rabbit proceeds to convince the now-curious townspeople, one after the next, to contribute individual morsels of food. The result is a hearty soup enjoyed by the whole group.

Much like the Stone Soup story, joint ventures ("Joint Ventures" or "JVs") involving information technology ("IT") arise from somewhat similar circumstances-two or more parties own certain assets which individually have limited value, but, when combined, represent potential value far in excess of the mere sum of their parts.

Unfortunately, while the Stone Soup lesson provides a recipe for cooperation and sharing, it leaves unresolved a potentially larger problem-what to do when cooperation fails or the Participants' interests diverge. These often overlooked (or ignored) but oft-litigated situations underscore the need for appropriate governance, valuation, dispute resolution and exit provisions as key components of any IT Joint Venture structure. And while the Participants must determine the value of each Participant's contribution to the JV at the onset and thereafter, the more troublesome dynamic arises when difficult decisions must be made at a time when the Participants may not be on the best of terms with each other, and the JV is unwinding.

This article will focus on general approaches to various aspects of IT Joint Ventures, with special attention being paid to successful exit strategies, with the ultimate goal of maximizing value while minimizing uncertainty. It is important to note that, because the specific elements of a successful IT Joint Venture are so intertwined with the tax and financial situation of the individual Participants, assessing specific JV structures for a particular group is best left to their own (and the JV's) tax and legal advisors.

Types of Joint Ventures

IT Joint Ventures come in many shapes and sizes, with the various Participants either bringing similar assets to the venture (such as synergistic technologies that, when combined, could realize a higher and better use of the technologies), or very different, although complementary, assets (such as one party possessing the technology and another party possessing unique skills in the commercialization of such technology). Additionally, the JV can be established as a stand-alone entity, a contractual arrangement between two or more pre-existing entities or a combination of both.

Structuring IT Joint Ventures involves virtually every aspect of the corporate world, mandating that the Participants take proper steps to ensure the JV's governing documents (license agreements, marketing agreements, shareholders' or operating agreements, etc.) provide direction on these aspects and resolve as many questions as possible, such as:

- Is the proposed JV structure appropriate for the Participants?
- Does the JV structure/commitment raise antitrust concerns?
- Is any Participant's involvement with the JV restricted, either legally or contractually?
- Can employees be "leased" to the JV by the Participants?
- How are the intellectual property rights in the various assets of the JV protected?
- Are the JV's operations and use of contributed assets consistent with each Participant's tax position?
- Regardless of the type of "asset" contributed to the JV by a Participant, three basic questions must be answered at the outset to avoid disputes down the road:
- What is the value of each Participant's contributions to the JV (and how will such valuation be determined)?
- Who will operate the JV, and control the use and commercialization of the assets being contributed?
- What dispute resolution/exit strategy will be used to resolve differences among Participants and possibly determine the ultimate fate of the JV?

Failure to fully and timely address any of these questions will most assuredly lead to disputes at some point that may not only prevent the full realization of the perceived benefits of the JV but, also, may result in actual economic losses to one or more of the Participants.

Valuation

Valuing the contributions to the JV is necessary for tax and accounting purposes, but also routinely serves as a basis for establishing ownership/control of the JV (if the value of such contribution is being used to determine the ownership interest of a Participant) and/or serves as a basis for determining the allocation of profits (or losses) generated by the JV. The ultimate goal is to value the contributions in the most expeditious and economical fashion, which ideally is by advance agreement of the JV Participants, with the blessing of their tax advisors and accountants. Valuation of the various contributions is an inexact process, however, as each Participant will likely attribute the greatest value to its own contribution, especially when the other contributions are not of similar items.

As an added twist, value determinations take on critical significance at least twice in any JV's life, once at the birth of the JV, to determine the "value" being contributed by each Participant (and the value of their economic interest, if applicable, in the JV), and again at the end of the JV, when the JV (or a Participant's economic interest) is being liquidated. While valuation methodologies vary, anyone contemplating participating in a JV should consult early and often with their financial and legal advisors to ensure the structure and the related valuations are consistent with each Participant's current financial and legal situation.

– Pre-Joint Venture Valuations

Valuations performed at the birth of the JV, while not necessarily without dynamics of their own, will never really lead to a "stalemate" of the type discussed below, as the Participants have the option of deciding not to proceed with the JV, and go their separate ways. As a result, most valuations at that time are driven by the tax/financial position of the various Participants, with further "value" being recognized in terms of revenue/income sharing arrangements. If the contributing Participants are unable to determine the valuation of their various contributions, an independent valuation firm may be retained. Obviously, while such a course of action may be completely fair to both Participants, it does involve an additional cost at a time when revenues are not yet being realized. In addition, unless the various assets being contributed to the JV are readily marketable, determining valuation may be more of an art than a science, causing further discontent among the Participants regarding respective value.

– Ongoing Valuations

Valuations after the JV's operations have commenced have a completely different dynamic, and failure to include effective governance, dispute resolution and termination provisions in the JV's governing documents will often result in stalemates during the ongoing operations of the JV, severely impacting the JV's viability as a going concern. And a Participant simply walking away is not an alternative. As discussed in more detail below regarding liquidation of the JV, or termination of a Participant's involvement in the JV, valuations at this stage usually take on one of three basic structures: (1) The Participants agree on the value; (2) The Participants agree on a third party, who then determines the value; and (3) The Participants agree to use a Buy/Sell process (which imposes a rationality, of sorts, to the valuation process). Any or all of these three approaches to valuation, or any variations thereof, can effectively be covered in the JV's governing documents.

Many times, the valuation of a Participant's initial contribution to the JV determines the ownership interest in the JV each Participant receives, which can result in one Participant holding a majority interest in, and therefore control of, the JV. While this avoids stalemates, it also will likely result in issues with the minority shareholders following the implementation of any "vision" by the majority Participant that isn't shared by the other Participants. If supported by the various Participants' advisors, the better approach from a governance perspective is to have the ownership interests of the JV be independent of the value of the contributions, with the JV's governing documents (and allocation of ownership interests) providing effective governance, and dispute resolution, procedures.

Control

As much as the creation and startup valuation of the JV can be seen as the "Honeymoon" phase of the JV, what soon follows is "The First Argument." While there may be some initial disagreements regarding the general operations or strategic direction of the JV, all Participants are generally very enthusiastic and supportive of the JV, and will keep the momentum strong in moving the JV forward, resolving issues quickly and decisively. However, at some point, the Participants are likely to face an issue/problem that is not so easily resolved, such as questions involving capital raising, changes in strategic direction, pricing of the JV's products and services, and even the performance (or lack thereof) of an individual Participant.

The common thread in most JV arrangements involves the Participants working in good faith to gain some sort of consensus on strategic matters. If consensus cannot readily be obtained, the governing documents should provide the mechanics for resolution, such as the Participants engaging an independent advisor (or mediator, if appropriate) to advise on the best course of action. The exercising of rights by a majority Participant to unilaterally resolve disputes, although common, may inflict long-lasting damage to the value and viability of the JV, as the other Participants may feel their interests are not being adequately represented. While engaging outside advisors is always an option, such actions will subject the JV to additional expenses and detract resources from revenue-generating activities.

When it comes to control of the JV and the avoidance of disputes, the best theoretical position is to have unanimous consent for actions to be taken. However, unanimity is very difficult to achieve in all situations. A better approach may be to require a majority (or supermajority) vote on certain actions, coupled with a robust dispute resolution mechanism, which may include the ability of disgruntled Participants to reasonably exit the JV. However, any Participant exiting the JV will inherently weaken it, either financially or through disruption of operations, so such approach is a double-edged sword: By giving a Participant easy access to the exit door, the Participants' commitment to the enterprise may be fleeting.

To help mitigate the impact of a Participant's departure, steps should be taken at the initial setup of the JV, designed to ensure the ability of the JV to continue operations, at least for a period of time necessary to take corrective action. For example, if a Participant's contribution to the JV did not involve an "asset" actually being contributed to the JV, and instead involved contractual arrangements (such as a licensing agreement for any technology or intellectual property, or a services agreement for any marketing, managerial or distribution services), the agreement(s) would ideally allow the JV to continue to use such assets or services following the departure of the Participant. Clearly, given that the relations between the parties may thereafter be strained, to the extent such assets or services can be procured elsewhere, it may be enough for the applicable agreements to allow the JV to either renegotiate the terms of such agreements upon the departure of a JV Participant, or at a minimum give the JV time to engage a new provider of such products or services.

The Exit—Breaking Up is Hard to Do

At some point, the JV will end, and possibly be acquired by one of the Participants or another entity, or disband of its own accord. There are several reasons, and several strategies, for providing in the governing documents of the JV methodologies for the termination of a Participant's interest, or even of the JV itself. Many view discussions of JV exit strategies to be on par with discussing a prenuptial agreement–no one wants to have the discussion, and neither party (presumably) wants to ever revisit the agreement. However, the JV exit strategy discussion does not need to be a negative event; an exit strategy could just be the methodology to be used for determining the profitable sale of the JV as an ongoing concern. And even if the strategy involves the unwinding of the JV, if done properly, an exit strategy should allow the Participants to realize the maximum value from such a breakup.

While state statutes provide some direction and methodology for resolving disputes within the JV or among the Participants, there is really no reason why these paramount issues cannot be dealt with before the JV commences operations. Addressing critical issues at such time also provides the added benefit of highlighting any inability of the Participants to work together, which may foreshadow potential issues in the ongoing operations of the JV itself.

– Deadlock

Regrettably, a very common trigger for exit strategies is the inability of the Participants to decide on a common course of action, resulting in deadlock. Practically speaking, whenever any Participant leaves the JV, they take with them certain financial and managerial support, and possibly a key asset of the business of the JV. A deadlock cannot be allowed to remain unresolved, as standing still is no viable option for any JV. Most JV governing documents will provide for certain specified decisions to be made by any Participant or by some form of consensus. However, any major decision that will affect the valuation of a Participant's interest in the JV, the viability of the JV, or increasing liability of the remaining Participants or the JV, among others, will be issues that likely will cause deadlock. Therefore, it is in the best interests of all involved to determine, before the creation of the JV, what actions to take when facing a deadlock.

Deadlock is not the only situation triggering an exit provision, as another common trigger is the default by a Participant in its obligations to the JV, or under the ancillary agreements with the JV. Regardless, two basic tenets should be followed when structuring exit strategies: (1) The exit strategy should never be so simple as to allow a path of least resistance for Participants when disputes arise in the ongoing business of the JV; and (2) The exit strategy should be structured in a manner that maximizes the value of the JV and, if desired, allows the JV the option to continue as an operating entity.

A common approach for the departure of a JV Participant is a buy/sell provision in the JV's governing documents that specifies how and to whom an exiting Participant can sell its shares. This may be further refined to require a right of first refusal (or right to purchase) by the JV, followed by a secondary right by the other Participants to purchase the departing Participant's shares in the JV, followed by the ability of any one Participant to acquire all of such ownership interest, followed finally by the ability of the departing Participant to sell its ownership interest to a third party. Again, however, the valuation of the ownership interest will likely be an issue, as many times such interests will not have readily ascertainable value.

– **Exit Valuations**

The Participants can agree beforehand that their ownership interests will be valued based on book value, which value should be relatively easy to determine based on the most recent financials of the JV. However, book value can understate the value of a profitable JV, or assets with substantial intangible value. Alternately, the Participants can agree that the ownership interest will be valued by an independent valuation firm. As mentioned earlier, such valuations can often be an imperfect science, usually involving a range of values, and create additional expenses for the JV for such services.

Another approach that has fairly widespread acceptance in the right circumstances is a variation of the "Dutch Auction," whereby the JV's governing documents dictate that a departing Participant can offer its ownership interests to the JV or the remaining Participants at a set price. Concurrently, however, such offer to sell also constitutes an offer by such Participant to buy everyone else's ownership interests at the same set price per unit. The advantage of such a structure is that it effectively requires the departing Participant to be very careful not to overprice its ownership interest, as the pendulum will swing both ways on that overvaluation. The downside is that oftentimes a departing Participant will not have the wherewithal to buy out the remaining Participants, so such a structure may be ineffective.

Conclusion

Regardless of the methodology used, the most important aspect of any successful JV is agreement, upfront by the Participants regarding any major points, which written agreement either sets forth how certain decisions will be made or valuations effected, or at least provides a mechanism to set such decisions in motion. Failure to take such precautions beforehand will surely result in resources being used inefficiently, both at the JV and the Participant level, and sometimes causing discord among the Participants. This is a very inefficient use of resources, as well as a very inefficient go-to-market strategy for any fledgling JV.

Once the agreement is reached, and the exit strategy laid out, if a Participant leaves the JV, it is vitally important to document the departure of such Participant, to ensure that all accounting and tax requirements can be met, and that no questions will arise after such departure. That way, although such departure may create a bump in the road for the JV, it is hopefully not the death knell for the viability of the JV or its operations.

Joint Ventures are the lifeblood of the IT world–without them, many technologies would never see the light of day. When properly structured and documented, JVs allow Participants to establish tolerable risk parameters, with the added benefit of a relatively high level of certainty of successful operation, for the entire life cycle of a new product rollout. If the Participants work together, no one will walk away hungry.

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