Joint ventures in a crisis

Maintaining the balance

Almost all businesses are facing unprecedented challenges in the global Covid-19 pandemic. But these challenges are, in a number of ways, heightened in a joint venture situation. With greater risk of misalignment between shareholders, JVs could be slower to deal with issues in the short term and left in a very different shape to navigate the medium and long term. This briefing considers some of the pinch points which may arise in a corporate JV (but many observations apply similarly to unincorporated JVs and strategic alliances) and how a joint venture agreement (***JVA***) may help or hinder parties when dealing with the impact of Covid-19.

Good governance and big decisions

- *The elephant in the Zoom*: The pandemic is straining the ability of boards to maintain existing governance standards, not least given the increase in remote working. Shareholder-appointed directors on JV boards will be focused on ensuring that reporting lines are maintained (if not enhanced), and management continue to be held to account. Some JVs are creating Covid-19 committees to accelerate decision-making – clearly all shareholders will have an interest in the composition and scope of any such delegated authority at such a critical time – and directors should be mindful that decisions taken during the pandemic will inevitably be judged with the benefit of hindsight. Add to this the complexity of tax residence risks for a JV (see further here) and the need to tread carefully to maintain good governance is clear.
- *The big decisions*: Many JVs will need to make quick and difficult operational decisions to respond to the rapidly changing environment created by the pandemic. These may meet reserved matter thresholds or trigger veto rights under the JVA. Some JVAs allow for consent by a shareholder-appointed director on behalf of their appointor, allowing the decision to be made on shorter notice. Directors wearing these two hats need to be clear in which capacity they are acting and to whom they owe their duties (in particular, directors of JVs approaching insolvency may need to shift their focus away from their appointing shareholders to creditors). Deemed consent provisions may be useful, but also present a danger to distracted shareholders, whilst shareholders without board representation or vetoes may be particularly exposed. And the longer the pandemic continues, questions of future strategy will need to be tackled when approving new business plans and budgets. These discussions will provide plenty of room for disagreement between shareholders, particularly as to capital allocation and distribution policies. Early and constructive engagement with partners could help.
- *Stalemate and checkmate*: JVAs often include a deadlock mechanism triggered if shareholders cannot agree on a reserved matter, or on the business plan or budget. This may also be triggered by other events, such as a quorum not being present at a number of consecutive board meetings. A period of escalation and/or mediation may follow. The status quo may prevail, which could be unworkable in the rapidly changing business environment resulting from the pandemic, or forced buyout provisions may be activated. Where the latter are present, the more cynical observers may see opportunities for shareholders to engineer deadlock to allow them to acquire a further stake in the JV (and potentially alter the governance balance) at a time when most assets have seen their market value decline.

Plugging a funding gap

- *Sources and uses*: Many JV businesses will require further funding to mitigate the liquidity challenges resulting from Covid-19. Competing priorities among shareholders as to their own capital allocation and, where the JV is consolidated with a shareholder, the balance sheet impact of further debt financing, could prove fertile ground for misalignment. JVAs should be reviewed for applicable funding requirements and processes. Specific formats or structures for further fundraising may be prescribed. Raising external debt could be subject to reserved matter approvals – particularly where the indebtedness proposed is material, affects pre-defined parameters (such as leverage ratio covenants) or requires a guarantee or security – generating scope for negotiation between shareholders. And a material decline in business performance coupled with increased debt levels may push JVs outside of pre-agreed financing policy parameters. In some cases, shareholders might be under commitments to advance further funding themselves. In others, shareholders may have no such commitment, or any shareholder funding requirement may be triggered only once external financing options have been exhausted. Shareholders that are not willing or able to participate in any shareholder funding will need to carefully consider the implications; for example, triggering a default (see below) or the risk of dilution (and any associated impact on future governance, economics and consolidation).

- *'Emergency' funding*: The JVA may include an emergency funding mechanism to allow the JV to source funding from individual shareholders under a streamlined process, which often circumvents (at least temporarily) pre-emption rights. Shareholders not providing the emergency funding initially might be able to avoid dilution or other longer-term consequences by exercising a catch-up or 'follow your money' right. It is crucial for shareholders exercising such rights to ensure that any prescribed processes and deadlines are rigidly observed to avoid the risk that the immediate consequences of emergency funding become permanent.
- *Swift exits*: Shareholders may come under pressure to fund other parts of their business or portfolio companies, whether as a result of contractual obligations or strategic priorities. As a result, we may also see more shareholders looking to dispose of interests in JVs to raise cash. JVA pre-emption rights – whether a right of first refusal, right of first offer or another construction – will likely include prescribed processes and timeframes, whilst drag-along and tag-along rights have the potential to both help and hinder the process. Selling shareholders could try to stretch the interpretation of permitted affiliate transfers or face difficulties if they are trying to move quickly to raise urgent funds, with the risk of default (see below) also increasing. And non-selling shareholders will need to weigh up the funding required to exercise pre-emption rights against the potential for a new JV partner (usually not of their choosing) to come on board at a time of crisis. Exit processes could also be impacted by extended merger control timelines or the tightening of foreign investment regimes as a result of the crisis.

A rise in defaults?

- *Trigger happy*: The myriad of Covid-19 challenges increase the possibility of a shareholder defaulting under the JVA. Defaults can arise from a breach of the JVA (eg where funding obligations are not met, or non-compliant stake sales are executed), as well as other triggers such as insolvency of a shareholder. Shareholders need to look carefully at the default triggers and related definitions in the JVA. In many cases, for example, definitions of shareholder 'insolvency' can extend to another member of its group being unable to pay its debts or commencing discussions with creditors. If possible, shareholders should get a full picture of the insolvency definitions across all their JVs and then build a set of do's and don'ts, to avoid accidentally triggering a default when reshaping their financial position.
- *The outcome of default*: Consequences of default vary significantly under JVAs, from call options allowing non-defaulting shareholders to purchase the defaulting shareholder's stake (possibly at a discount), to a loss of economic and governance rights or, less commonly, winding-up of the JV. Cross-default could follow, and industry specific consequences could also apply (eg a loss of entitlement to hydrocarbon production in an upstream oil and gas context). Cure periods might help, but equally may not buy enough time. Given the potential remedies and the impact they could have on a shareholder's ability to realise (or even hold on to) its investment or influence the business of the JV, shareholders need to be actively monitoring compliance across their JV interests. And non-defaulting shareholders may look for an opening, particularly where call options are priced at a discount to market value.

Alon Gordon
Counsel
T +44 20 7427 3960
E alon.gordon@freshfields.com

Richard Johnson
Senior Associate
T +44 20 7427 3944
E richard.johnson@freshfields.com

Lucy Cliff
Associate
T +44 207 785 2557
E lucy.cliff@freshfields.com