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JOINT VENTURES AND ALLIANCE ISSUES IN THE AUTOMOTIVE SPACE

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Morgan Lewis Automotive Hour Webinar Series

Series of automotive industry focused webinars led by members of the Morgan Lewis global automotive team. The 10-part 2019 program is designed to provide a comprehensive overview on a variety of topics related to clients in the automotive industry. Upcoming sessions:

DECEMBER 11 | Privacy Considerations and the Use of Collected Data

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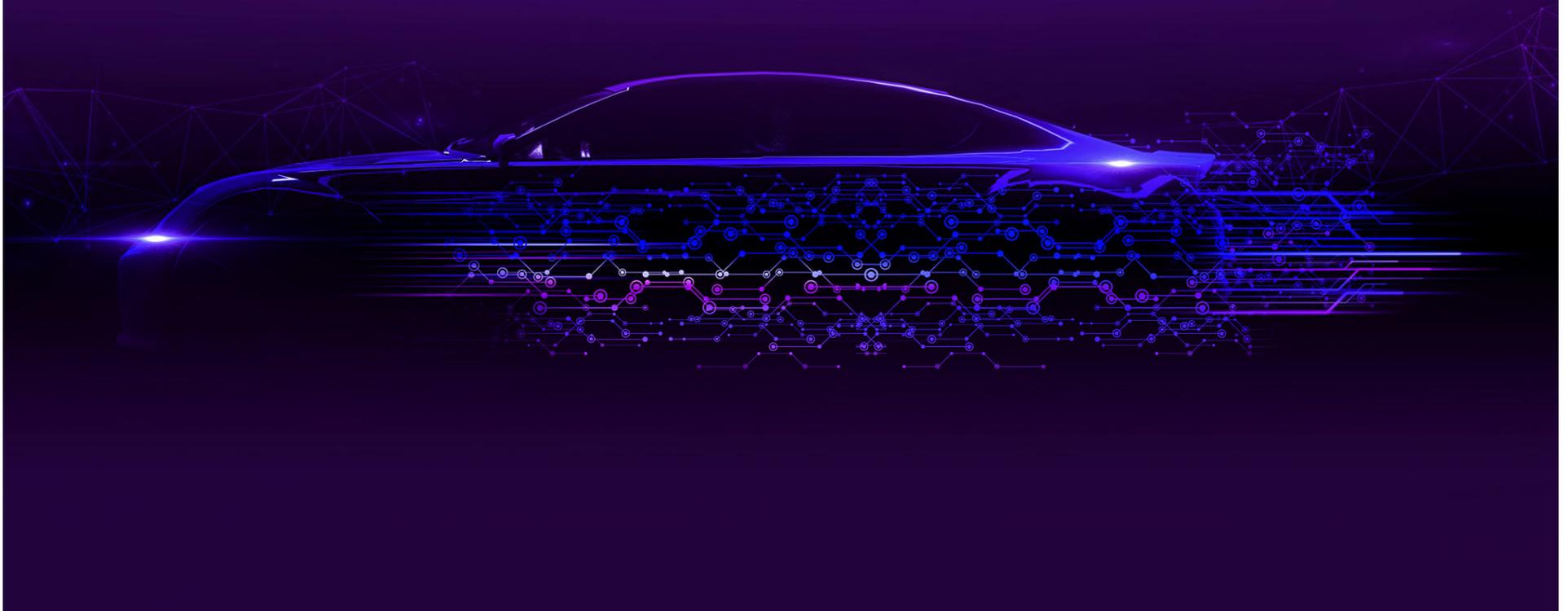
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SECTION 01

INTRODUCTIONS



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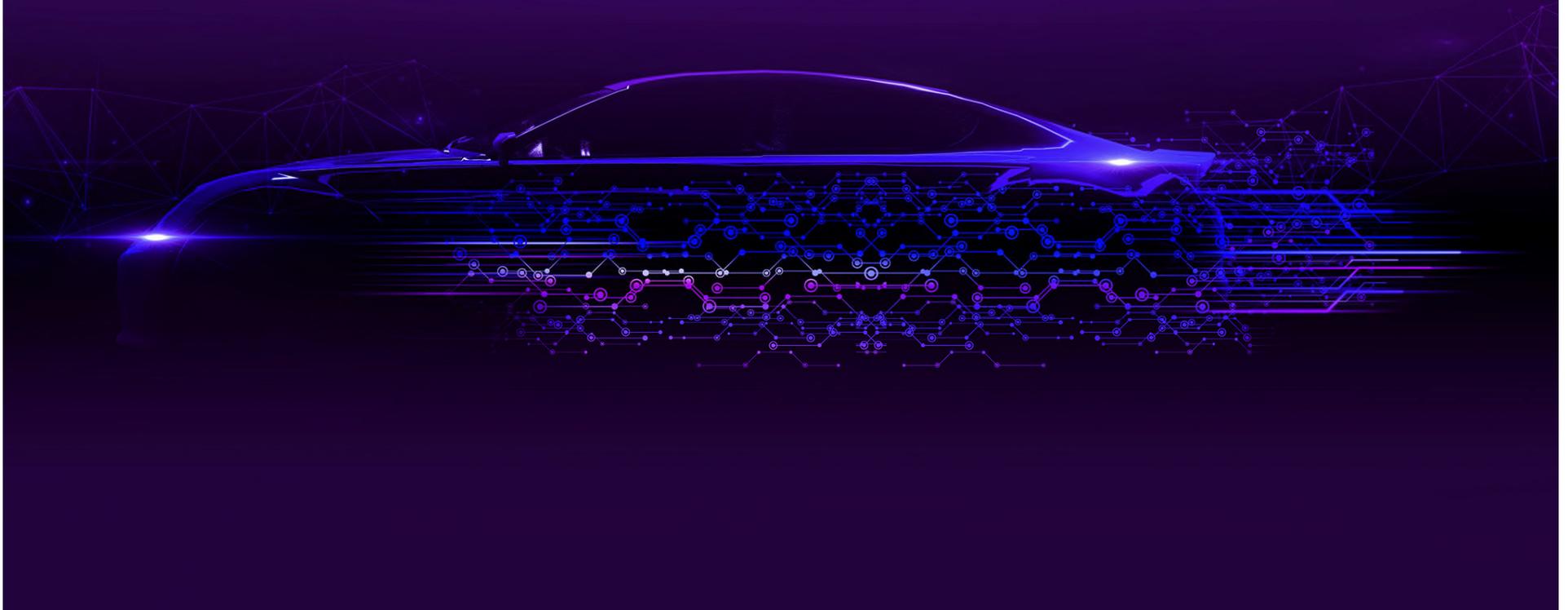
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SECTION 02

STRUCTURING ENTITY JOINT VENTURES



Threshold Structuring Question: Entity or Not?

- The classic joint venture is an entity jointly owned by two or more co-venturers.
- However, joint ventures can also be accomplished without an entity, through what is essentially one or more (often very complicated) commercial contracts.
- Parties have various reasons for choosing non entity joint ventures.
 - Sometimes there is a perception that they are easier to unwind if they do not work out – not always true.
 - Sometimes the relationship is simple enough that the effort to work through the tax, accounting, governance and other matters associated with the formation of a jointly owned entity does not seem worthwhile.
 - In the automotive space, however, we may be witnessing another reason: the desire to retain flexibility – and not commit to any single platform or technology – at a time when many of the foundational principles of the industry may be changing.

Structuring an Entity Joint Venture

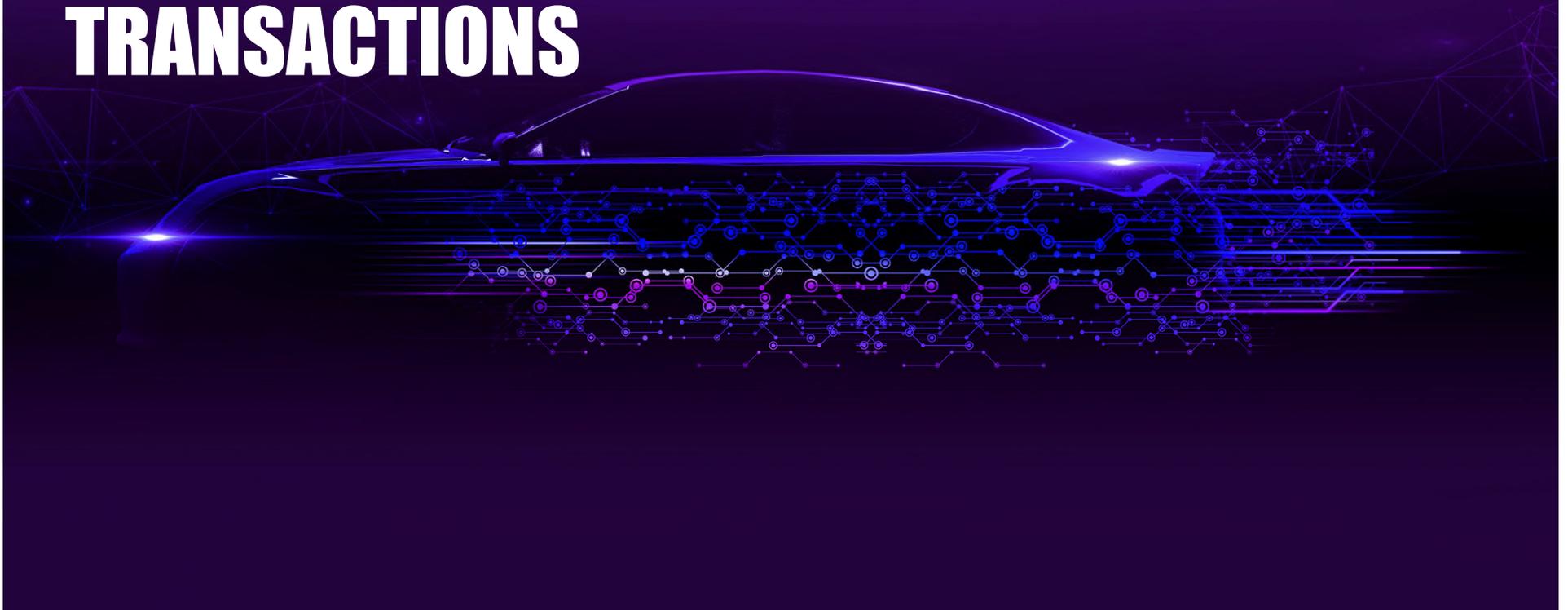
- One of the preliminary decisions to be made is what sort of entity to use.
 - The choice is often driven by tax considerations, but other considerations may also be relevant.
- The most common choices today are a corporation and a limited liability company, or LLC.
 - Both forms limit the liability of their owners to the amount of the owners' investment, and assuming that proper company formalities are observed, the liabilities of the entity should not become liabilities of its owners.
 - However, a corporation is subject to tax at the entity level in part because, if any of its owners are entities, it cannot elect to be treated as an S corporation and enjoy pass through treatment.
 - In contrast, an LLC does not as a general matter incur entity level tax, making it a more tax efficient choice in many circumstances.
 - LLCs also offer almost unlimited flexibility in terms of capital structure, governance and other matters.
- In cross-border JVs, there may be parallel US and non-US vehicles (which may also lead to different conclusions by the venturers regarding the pass-through nature of the entities.)

JV Scope and Related Matters

- What will the scope of the JV be – both substantive and geographic?
- Can the scope be modified? What level of approval is required?
- Is the JV to be the exclusive vehicle through which the venturers engage in the JV's business? Will the venturers be required to agree not to compete with the JV?
- Relatedly, will the venturers be required to present to the JV business opportunities falling within the JV's scope? If so, what happens if the JV declines the opportunity?
- If aspects of the JV are agreed not to be exclusive, consider making that agreement explicit in the transaction documents to help prevent claims based on common law duties or other extra-contractual theories.

SECTION 03

IP ALLOCATION ISSUES IN JOINT VENTURE TRANSACTIONS



IP Allocation Mechanisms

- The magic of IP:
 - You can keep it and give it away at the same time!!
- IP Allocation Tools
 - Assignment
 - Licenses
 - Covenants not to sue
 - Non-competes

IP Allocation Mechanisms

- Assignment
 - Usually all IP rights
 - Creative use of assignment coupled with:
 - Licenses
 - Covenants not to sue
 - Non-competes

IP Allocation Mechanisms

- License
 - Infinite divisibility
 - Parameters
 - Specific IP rights
 - Exclusive/sole/non-exclusive
 - Field of use (“FoU”)
 - Improvements
 - Sub-licensable
 - Transferable

IP Allocation Mechanisms

- Covenant not to sue
 - Like license
 - Personal? => does not run with IP
 - Applicability of patent exhaustion/first sale
 - Breach of prior exclusive license grant?
- Non-competes
 - Used in conjunction with assignments and licenses
 - IP ownership is not (always) enough to exclude others:
 - Copyright => independent development defense to infringement
 - Trade secret => independent development defense
 - Patent => no independent development defense, but “design around”

Example - Technology Development JV

- Defining the IP “Buckets”
 - Background IP
 - Venturer IP in pre-existing technology or technology developed during but outside JV
 - Licensed into JV
 - Foreground IP
 - IP in technology created pursuant to JV
 - Key issue: Rights in Foreground IP?

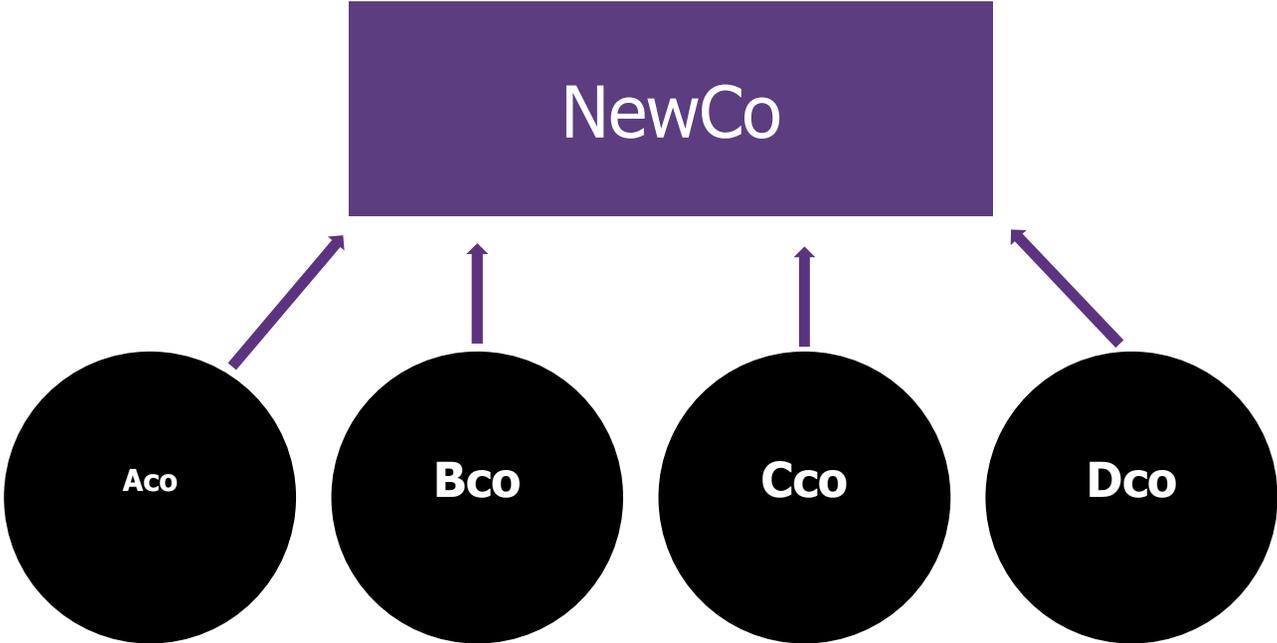
Example - Technology Development JV

- Rights in Foreground IP
 - Default rule for joint development
 - => Joint Ownership!
 - Beware J.O. under U.S. law
 - Exploitation: each J.O. may
 - fully exploit and license third parties
 - Patent: without accounting
 - License competitor infringers royalty free!
 - Copyright: duty to account
 - Enforcement of J.O. IP under U.S. law
 - Both J.O.s must join
 - May result in inability to enforce!

Example - Technology Development JV

- Treatment of Background IP
 - Ownership
 - Venturer/Creator
 - Licenses
 - Each Venturer licenses BG IP to NewCo only
 - Exclusive within “NewCo FoU”
 - = JV investment + \$ maybe
 - Enforcement
 - Venturer has right to enforce, but no obligation
 - If not, then maybe NewCo gets to enforce
 - Maybe NewCo gets first right within “NewCo FoU”

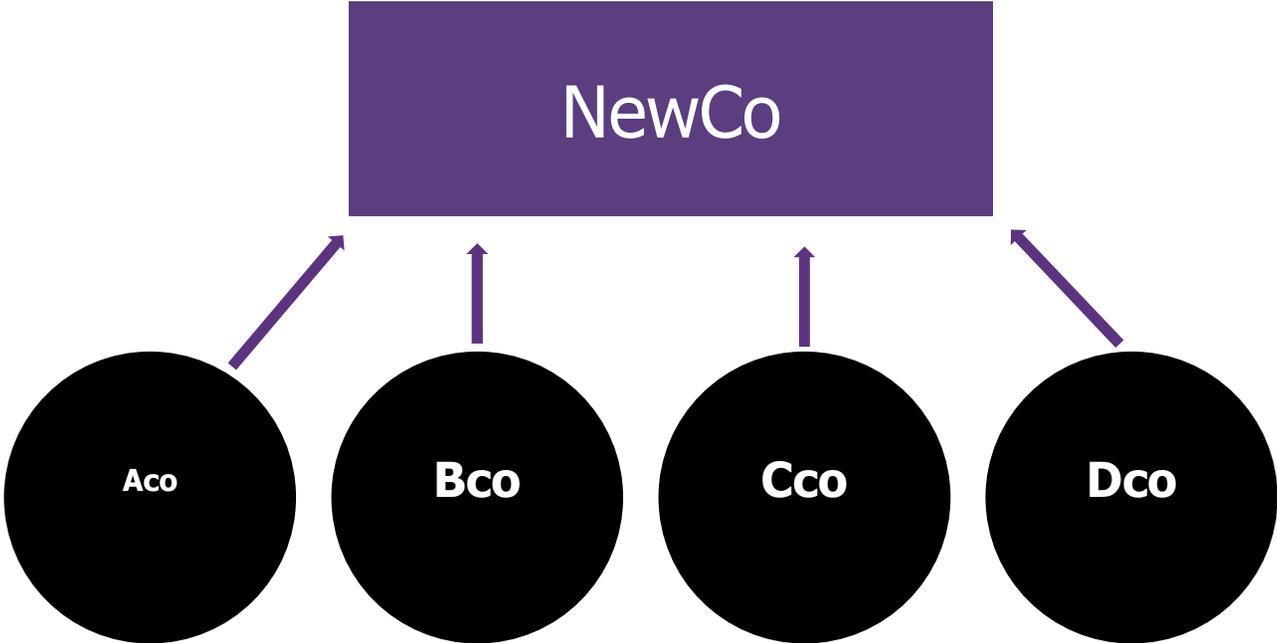
**Background IP licenses
Exclusive in "NewCo FoU"**

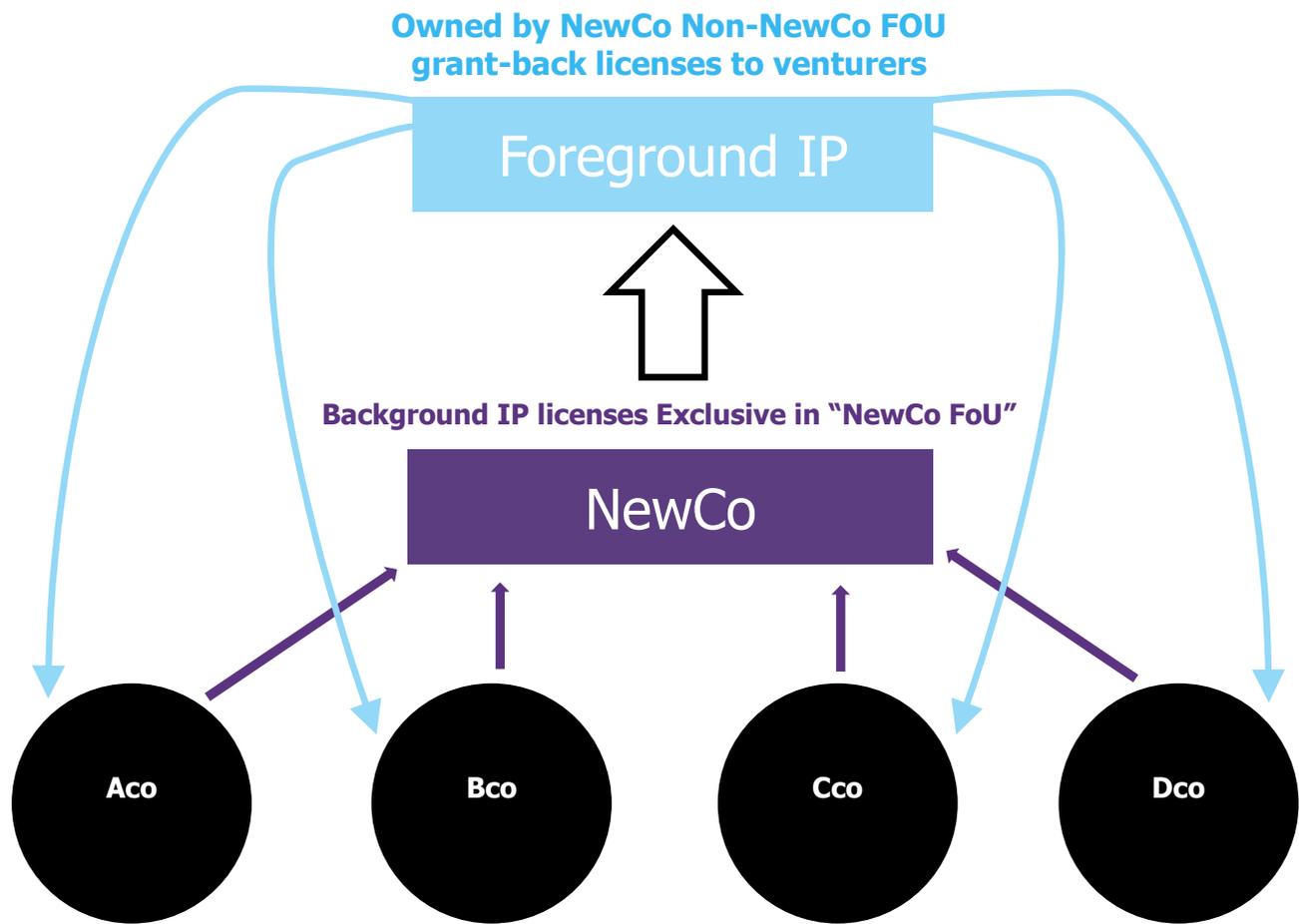


Example - Technology Development JV

- Treatment of Foreground IP
 - Ownership
 - NewCo but subject to “Non-NewCo FoU” restrictive covenants
 - Licenses
 - Non-Exclusive to each Venturer within “Venturer FoU”
 - Enforcement
 - Always NewCo’s right
 - Patent prosecution
 - NewCo

**Background IP licenses
Exclusive in "NewCo FoU"**





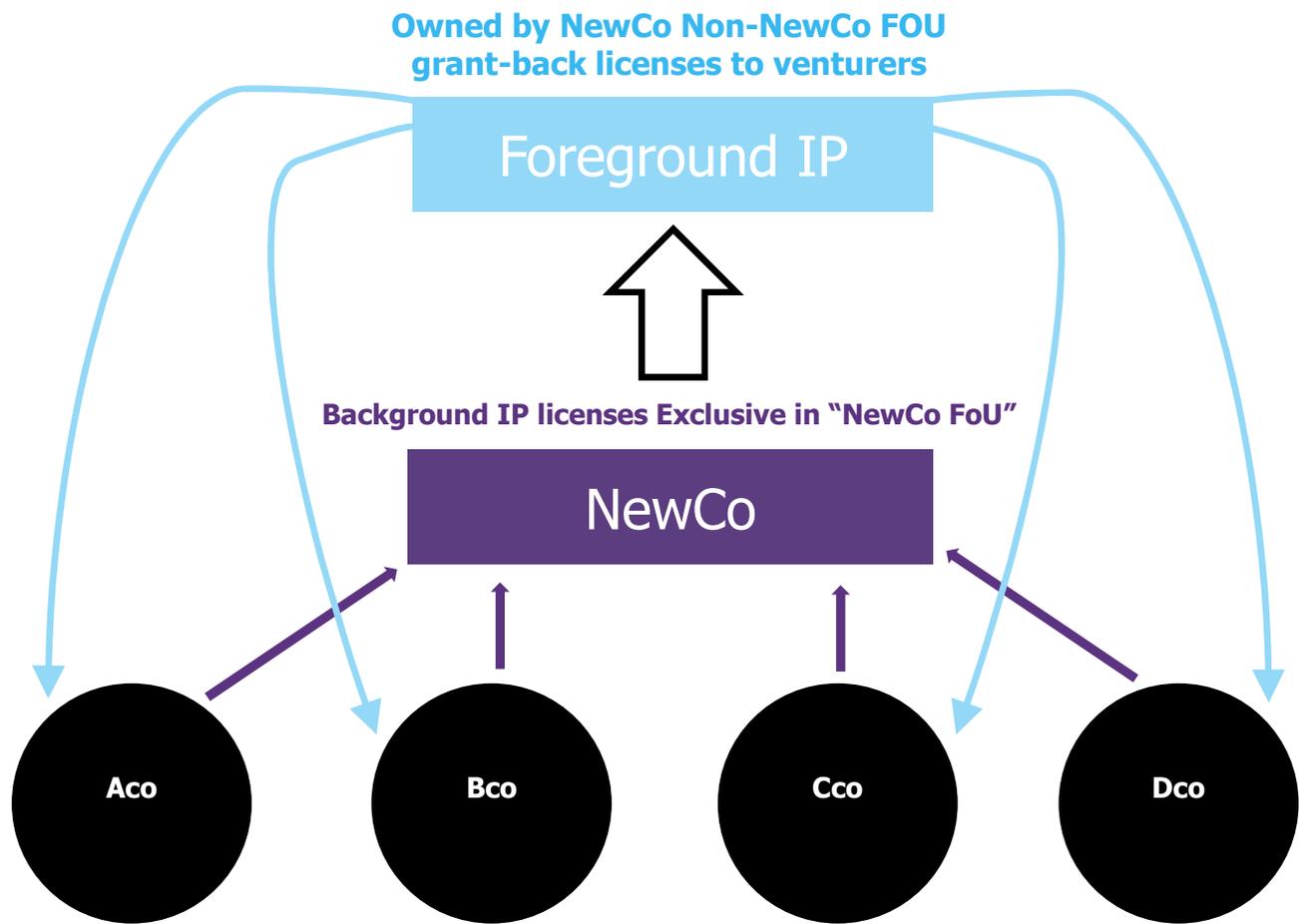
Example - Technology Development JV

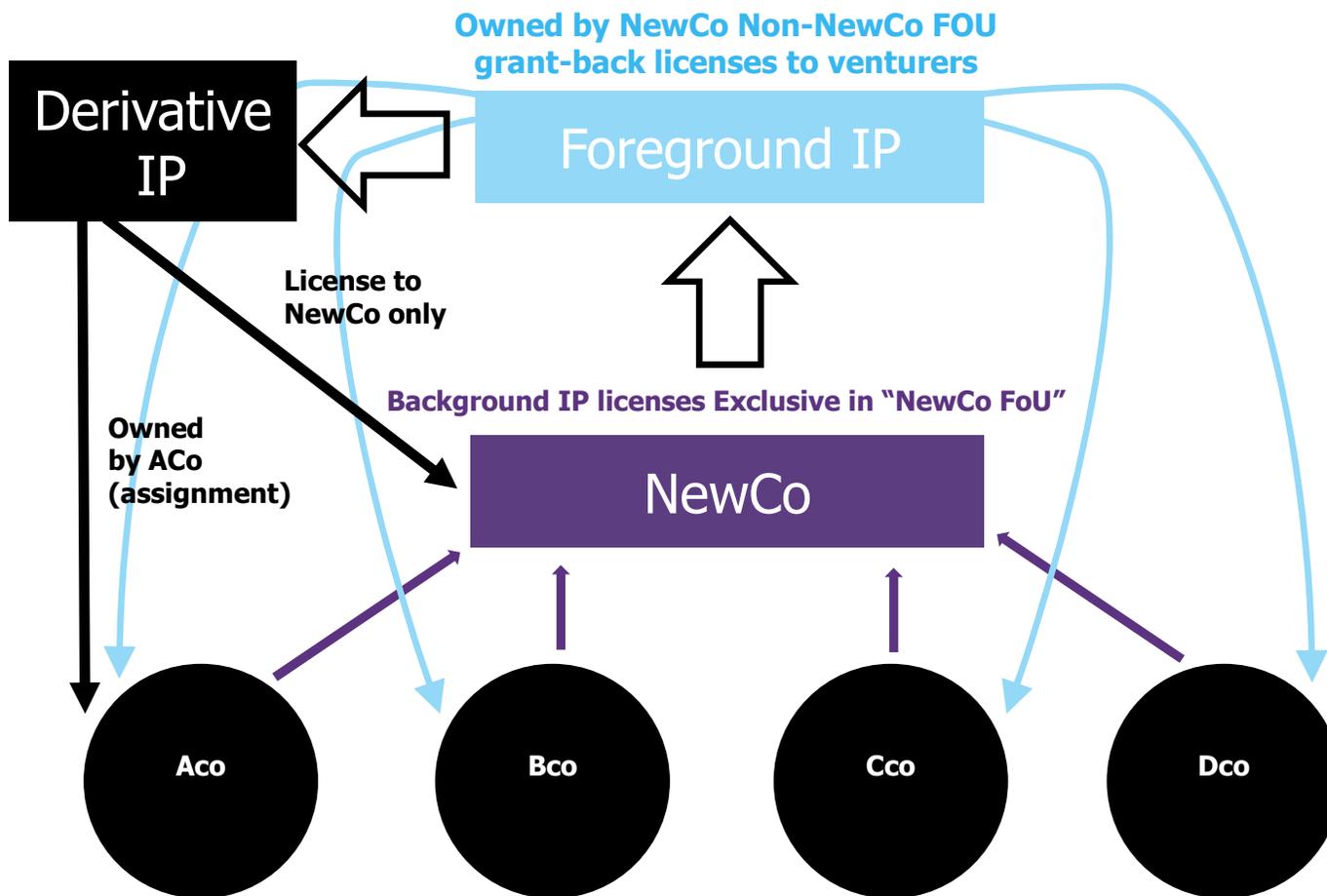
- Derivative IP
 - Special class of FG IP – IP in new technology derived from one Venturer's core technology
 - Ownership
 - Venturer whose core technology is extended
 - Licenses
 - Exclusive FoU license to NewCo
 - No license to other Venturers (esp. if potential competitors)

Example - Technology Development JV

Derivative IP (cont'd)

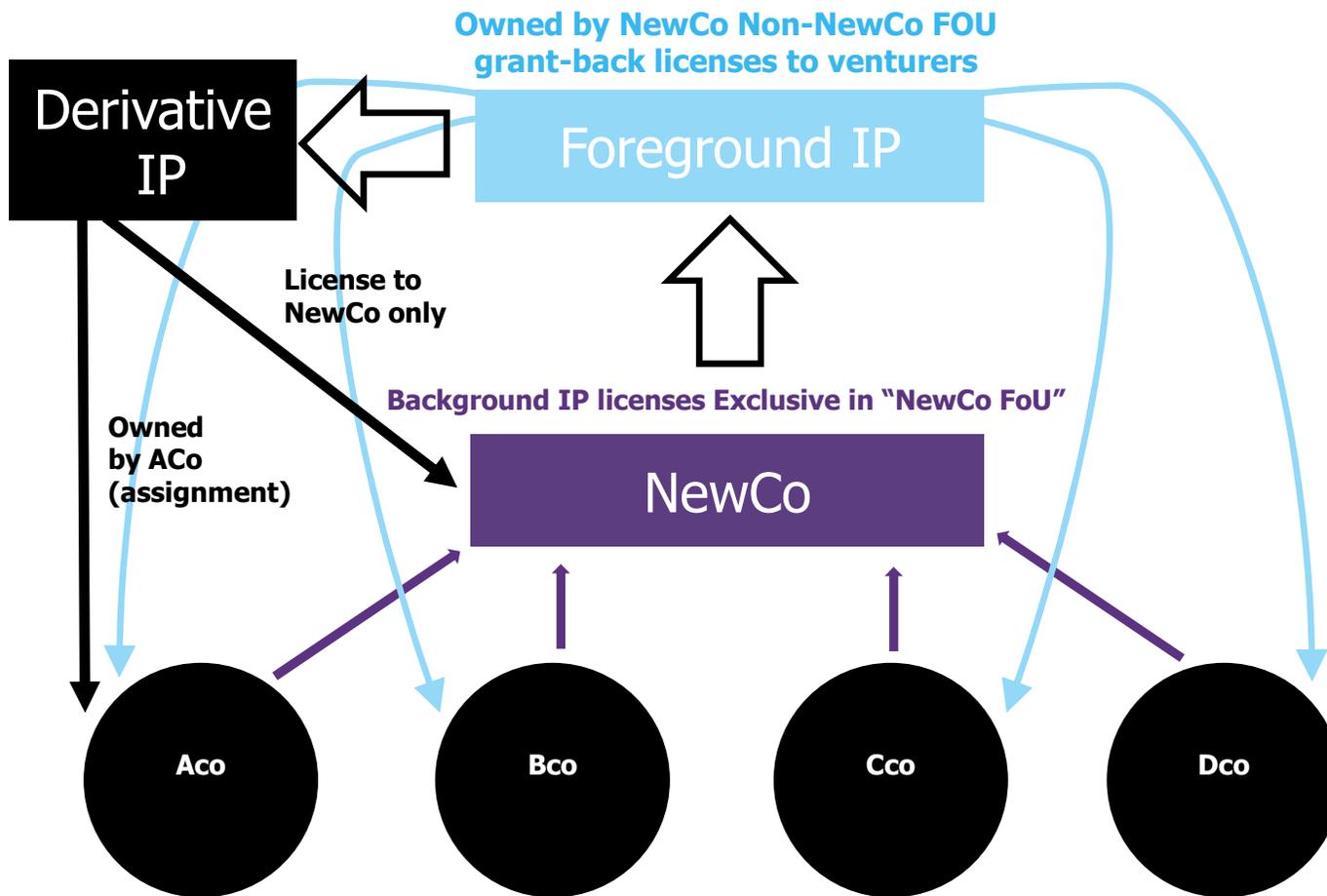
- Enforcement
 - First Venturer, if not NewCo
- Patent prosecution
 - First Venturer, if not NewCo
- Protects core technology of each Venturer from other Venturers
- Encourages openness with Newco re “core” technologies (crown jewels)

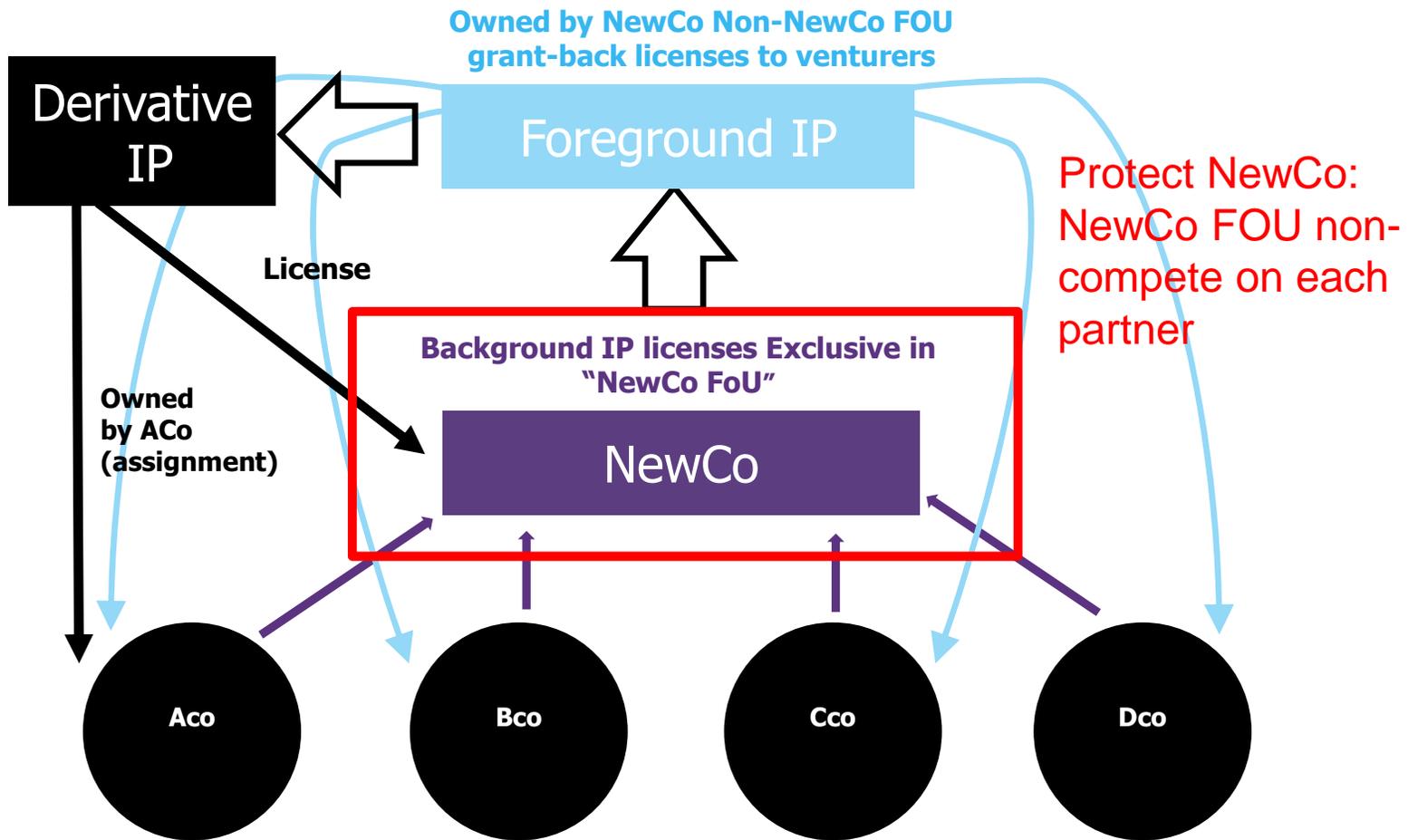




Example - Technology Development JV

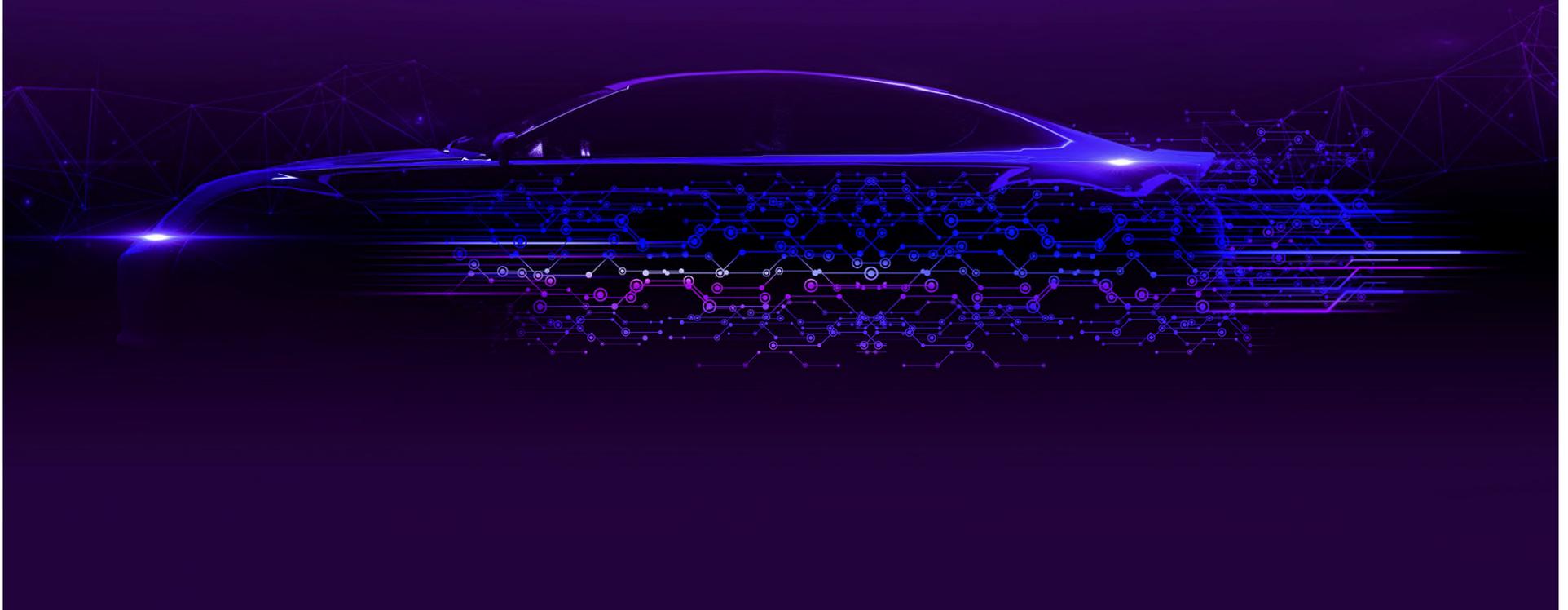
- Non-Competes
 - Venturers subject to “NewCo FoU” non-compete
 - In addition to Exclusive NewCo FoU license
 - Prevents development of non-infringing but competing technology (i.e. design around technology)





SECTION 04

ECONOMICS AND CAPITAL



What do the venturers contribute initially to the JV and, if not cash, how are the contributions valued?

- In a JV in which two venturers are each contributing non cash assets, it can be useful to think of each venturer as both a buyer and a seller.
 - This approach can in some circumstances make deal terms easier to negotiate.
 - Do not, however, dismiss without careful consideration the need to perform due diligence, potentially including third-party valuation work, on the assets being contributed by the other venturer.
- If working capital items (e.g., accounts receivable, inventory) are contributed, consider whether a mechanism to adjust the value of the contribution (and possibly the contributing venturer's equity) is advisable.
- If the contributed assets are not as advertised, and representations and warranties of the contributing venturer are untrue as a result, what is the remedy?
 - Payment from the JV to the non-contributing venturer could be cold comfort because, although the non-contributing venturer may be made whole economically, the value of the JV is further reduced.
 - Payment of a proportionate share of the loss directly from the contributing venturer to the non-contributing venturer may put the venturers in the same place economically, but does not help the JV.
 - Payment from the contributing venturer to the JV may be the best alternative if the facts permit.

Where will the JV obtain capital to operate?

- Will the venturers be required to put in more capital? Under what circumstances? What happens if one venturer makes an additional capital contribution and the other does not?
- Will third parties be allowed to become additional equity investors? On what terms? Will the existing venturers have preemptive rights?
- Will the JV be allowed to raise third party debt?
 - If so, each venturer should ensure that any such debt does not trigger an event of default or otherwise implicate any of such venturer's existing debt financing arrangements.

How are profits and capital returned to the venturers?

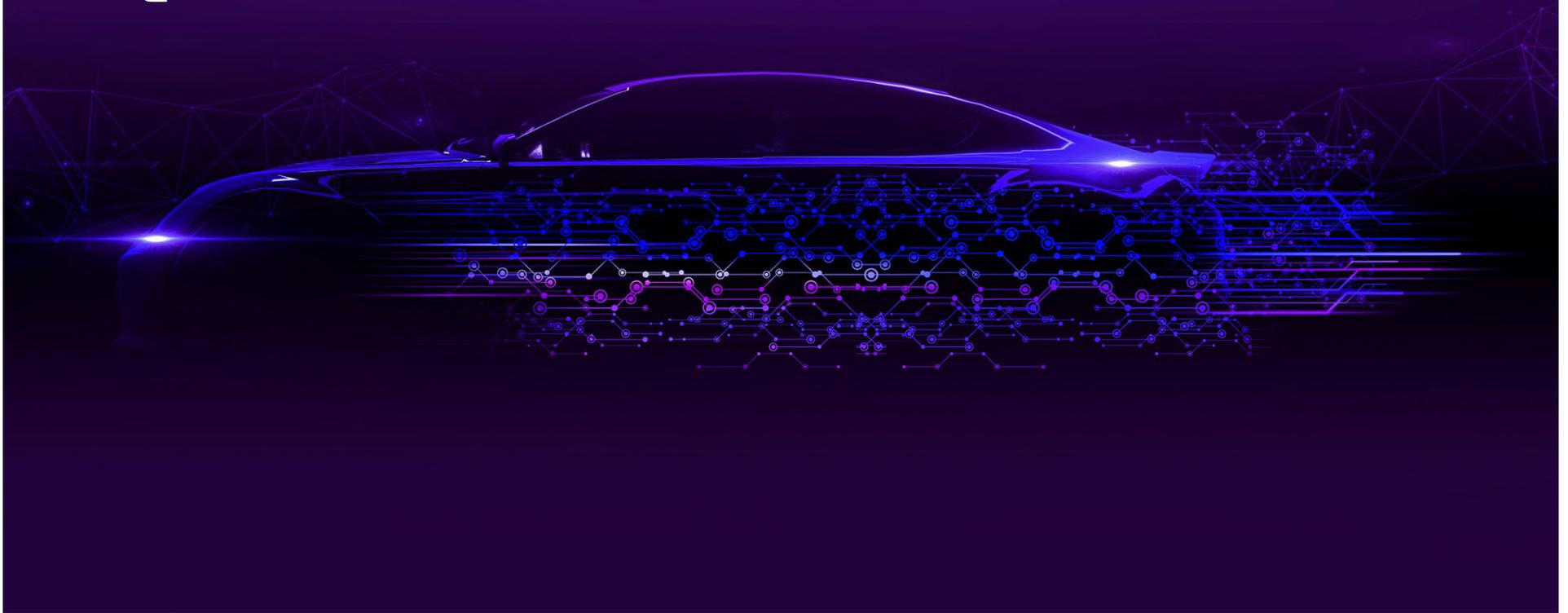
- Dividends and Other Distributions – do the venturers have a guaranteed return?
 - What do the distribution provisions (or “waterfall”) look like? This is one of the most important parts of any JV arrangement, and requires the business and legal terms to be aligned.
 - In a corporate JV, the waterfall is usually set forth in the charter provisions governing preferred stock.
 - An LLC offers potentially more flexibility, with an almost unlimited variety of capital interests, carried interests, preferred returns or hurdles, catchups and participation rights.
- License Fees – given the technology heavy nature of the automotive industry, these could be significant.
- Management Fees – more common in some industries than others, particularly if one venturer is providing more of the human capital to make the JV go.
- Interest on Loans from Venturers – would tend to be paid ahead of any returns on equity.
- Tax Distributions – likely necessary or advisable if the JV is a pass-through entity (such as an LLC) to enable the venturers to pay taxes on deemed income.

Will management participate in the equity of the JV?

- Often the prospect of equity participation is key to attracting a qualified management team (even from one or more of the venturers).
- If management equity is contemplated, what form should it take?
 - Management equity in a corporate JV is often similar to a traditional corporate equity compensation plan – a combination of options, restricted stock, stock appreciation rights and other equity-based compensation.
 - A Delaware LLC offers almost unlimited flexibility in this regard, and can issue profits interests, with value based solely on the future profits of the JV, in exchange for services. The interests can participate in the profits of the JV at various levels in the waterfall, and can be subject to vesting and forfeiture like equity-based compensation issued in the corporate context.

SECTION 05

GOVERNANCE AND LIQUIDITY



Governance

- Will the JV have its own management team? To what extent will management act autonomously?
- Will the JV have a board of directors or similar governing body? How will it be composed? To what extent must major decisions be elevated to the board level?
 - How are those decisions made (e.g., majority vote, specified supermajority, unanimity)?
- Does the potential exist for deadlock? If so, how is it to be addressed? Options include:
 - Do nothing and force the venturers to reach agreement.
 - Include on the board independent directors unaffiliated with any venturer.
 - Escalation Provisions.
 - Neutral Arbiters – depending on topic, could be an arbitration firm, accounting firm, valuation firm, etc.
 - Buy-Sell Provisions – can be very risky, but sometimes are the only option.
 - Termination of the JV.
- Will a business plan (ideally including a budget) be developed? Although not strictly a legal document, it can be instrumental in ensuring that the venturers are aligned regarding the commercial vision for the JV.
- Don't neglect the nuts and bolts. Basic corporate mechanics such as meeting notice requirements, quorum requirements, action by written consent, etc. can as a practical matter be just as important as the other governance provisions.

Fiduciary Duties and Related Matters

- Individuals wearing “two hats” (e.g., a director of a venturer and a director of the JV) need to be particularly careful.
- As a general matter, fiduciary duties can be waived by a Delaware LLC and its members, but that is often not a complete answer, particularly if the individual continues to have fiduciary duties to the venturer.
- Will directors and officers of the JV be indemnified for liabilities arising from their positions? If so, consider borrowing a page from the private equity playbook and making clear that the indemnification obligations of the JV are first in line, and any other indemnification rights (e.g., arising from the charter documents of the appointing venturer or an individual agreement) come into play only to the extent there are liabilities that are not satisfied by the JV.
- Will the JV obtain director and officer insurance? Although there may not be a large pool of public stockholders that could act as plaintiffs – at least at the outset – there may be enough risk of liability that a policy is justified.
- Pay attention to the specifics of any waivers of fiduciary duties. Members of a Delaware LLC can waive fiduciary duties to each other, which is often viewed as sensible in a joint venture between two or more sophisticated and well-represented parties. However, consider whether that waiver should extend to individuals serving as directors or officers of the JV. Both decisions can have consequences for the JV and the venturers.

Transfer and Exit

- One size definitely does not fit all in this category – careful thought needs to be given at the outset as to the objectives of the venturers and the JV itself.
- To what extent are the venturers allowed to transfer their equity interests?
- Is there a flat prohibition on transfer? Is it time limited?
- Do the venturers have a right of first offer (or ROFO) or right of first refusal (or ROFR) over transfers by other venturers? Do these rights achieve the business objectives in the case of disparities in the economic resources of the venturers?
- To what extent can one venturer participate in an otherwise permitted sale of interests by another venturer (tag-along rights)?
- To what extent can one or more venturers force other venturers to sell their interests in a sale of interests by the first set of venturers (drag-along rights)?
- Upon what circumstances, if any, can the JV go public? What rights do the venturers have in such circumstance? Consider building into the transaction documents the flexibility to restructure the JV as necessary to effect an IPO.
- Most Important: Does the set of transfer restrictions and liquidity rights comport with the business deal?

SECTION 06

ANTITRUST CONSIDERATIONS IN JOINT VENTURES AND STRATEGIC ALLIANCES



Potential Procompetitive Benefits of Joint Ventures

- Although the antitrust laws generally look skeptically upon agreements between competitors, courts and agencies recognize that legitimate collaboration among competitors may bring substantial benefits to consumers in the form of:
 - Faster innovation
 - Better-quality products
 - Lower prices
 - Greater manufacturing capacity
- In order to encourage procompetitive collaboration among competitors, antitrust law affords more lenient treatment to legitimate joint venture activity.

Potential Procompetitive Benefits of Joint Ventures

- While agreements among horizontal competitors are often condemned as *per se* unlawful, legitimate joint ventures are typically reviewed under the rule of reason.
 - “[J]oint ventures . . . hold the promise of increasing a firm’s efficiency and enabling it to compete more effectively. Accordingly, such combinations are judged under a rule of reason.”
 - *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 768 (1984).
- Courts look to substance over form, and simply labeling an agreement among competitors to fix prices or output as a “joint venture” will not avoid *per se* condemnation.

Antitrust Perspectives on Different Types of Joint Ventures

- Joint ventures can take a number of different forms.
 - Fully Integrated Joint Venture - characterized by the integration of a full line of business, including manufacturing, distribution, marketing, and sales.
 - *United States v. Penn-Olin Chemical Co.*, 378 U.S. 158 (1964) (analyzing the creation by market rivals of a fully-integrated joint venture to build and operate a chemical plant).
 - Research Joint Venture - characterized by the sharing of information among competitors in order to realize economies of scale, complementary skills, and more efficient research and development.
 - Research joint ventures are generally evaluated under the rule of reason.

Antitrust Perspectives on Different Types of Joint Ventures

- Production Joint Venture - characterized by the integration or creation of a shared production facility.
 - Like research joint ventures, production joint ventures are typically evaluated under the rule of reason.
- Purchasing Joint Venture - characterized by competitors collaborating to jointly source inputs, including parts and raw materials in order to achieve economies of scale and increased purchasing power.
 - *E.g.*, creation by GM, Ford, and DaimlerChrysler of a single firm to source components in 2000.
 - Resulted in an investigation by the FTC into whether the arrangement violated the Clayton Act, but the investigation was closed in September 2000 without enforcement action.

Examples of Joint Ventures in the Automotive Industry

- A number of characteristics of the automotive industry make it conducive to joint ventures, including:
 - Significant startup costs
 - Comprehensive safety and environmental regulation require constant innovation
- There are many examples of joint ventures undertaken in the automotive industry:
 - In 1983, General Motors and Toyota entered into a production joint venture to produce vehicles at a former GM facility in California.
 - The FTC challenged the joint venture and obtained a consent order limiting the number of vehicles that could be produced per year, although the consent order was later set aside at the request of GM and Toyota.
 - *In the Matter of General Motors, Corp.*, 103 F.T.C. 374 (1984)
 - Hyundai and Aptiv recently formed a research joint venture to further autonomous driving technology.
 - BMW and Jaguar Land Rover recently formed a research joint venture to create electric vehicle technologies.

Joint Venture Safe Harbors

- The Federal Trade Commission and the Department of Justice have published the *Antitrust Guidelines for Collaborations Among Competitors*.
- The Guidelines set forth a number of “safe harbors” for joint ventures in which “anticompetitive effects are so unlikely that the Agencies presume the arrangements to be lawful without inquiring further into particular circumstances.”
 - Joint ventures in which the market shares of the collaboration and its participants collectively account for no more than *20 percent* of each relevant market.
 - Research and development joint ventures where there exist *three or more independently controlled research efforts* that have the necessary assets, characteristics, and incentives to engage in the same or similar research and development efforts.

EU Joint Venture Principles

- Virtues of joint ventures are also recognized under EU law.
 - Art. 101 (1) of the Treaty of the Functioning of the European Union (“TFEU”) or similar national competition law provision stipulates antitrust liability for anti-competitive agreements between undertakings
 - Art. 101 (3) TFEU exempts from antitrust liability certain agreements that contribute to improving the production and distribution of products or to promoting technical or economic progress; attention, however to so-called “hard core” restrictions, which can preclude exemption
 - EU Commission Guidelines on the applicability of Article 101 TFEU to horizontal co-operation agreements provide initial guidance for selected joint ventures between competitors including information exchange, research & development, production, purchasing, distribution and standardization agreements
 - Arm’s length principles apply between the venture and the venturers.
 - Full Function JVs may be subject to merger control at the EU Commission level (provided that the relevant revenue thresholds are met) (concept of full functionality similar to fully integrated JVs as described on above slides)

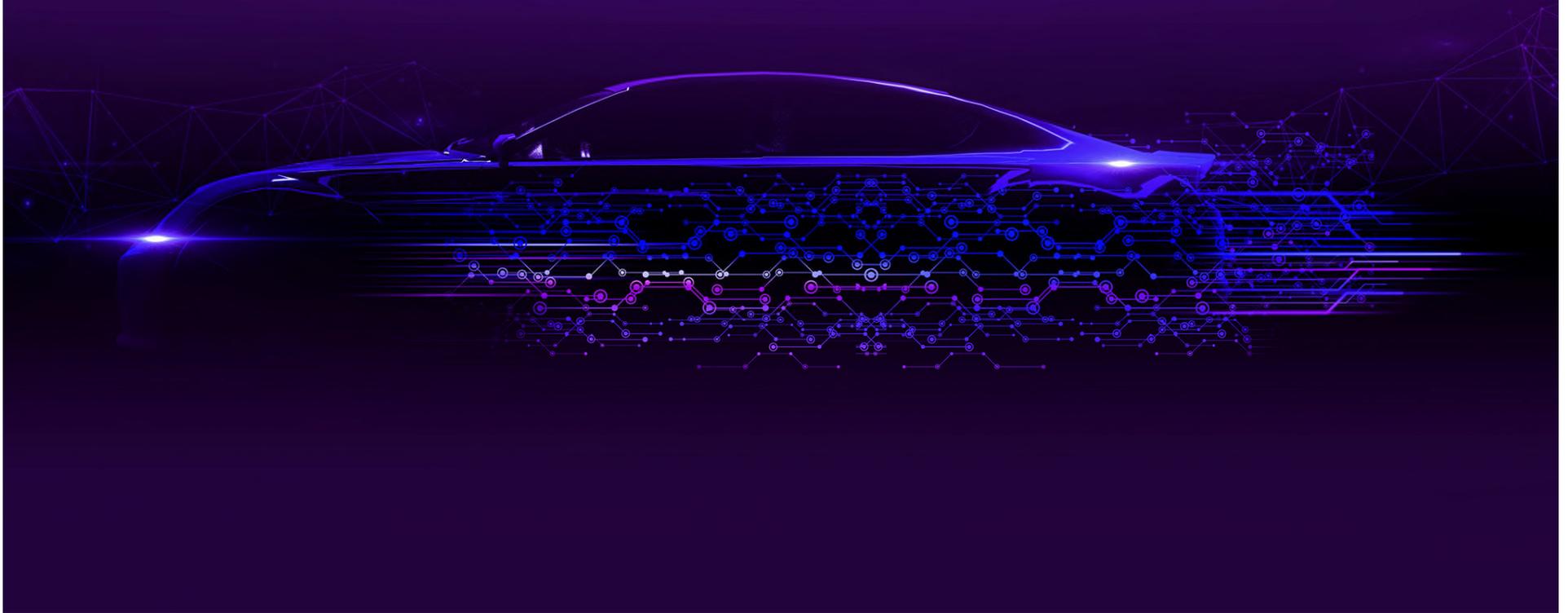
National Cooperative Research and Production Act of 1984 (NCRPA)

- First enacted by Congress in 1984 and expanded in scope in 1993.
- Provides that research and production joint ventures will not be deemed *per se* unlawful, but will “be judged on the basis of [their] reasonableness, taking into account all relevant factors affecting competition.”
 - 15 U.S.C. § 4302
- Parties may register a joint venture with the DOJ and the FTC in order to limit antitrust exposure to actual damages, plus costs and attorneys’ fees.
 - Removes the prospect of treble damages.
 - Prevailing defendants may recover costs and attorneys’ fees if an antitrust challenge is found to be “frivolous, unreasonable, without foundation, or in bad faith.”
 - 15 U.S.C. § 4304(a)(2)
- A “joint venture” includes a variety of different activities, including:
 - “Theoretical analysis, experimentation, or systematic study of phenomena or observable facts.”
 - “Development or testing of basic engineering techniques.”
 - “Production of a product, process, or service.”
 - 15 U.S.C. § 4301(a)(6)

Department of Justice Business Clearance Letters

- Parties interested in pursuing a joint venture may opt to consider seeking a business clearance letter from the Department of Justice.
- The DOJ is empowered under its regulations to issue informal advisory opinions when presented with requests from private parties.
 - 28 C.F.R. 50.6
- Business clearance letters are non-binding
 - The letter represents only the DOJ's then-present position. It is free to bring a later enforcement action.

QUESTIONS?



Today's Presenters – Questions?



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THANK YOU

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