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## CAUGHT BETWEEN A ROCK AND A HARD PLACE: How to Mitigate the Conflict of Interest Dilemmas Encountered by Joint Venture Directors



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### Introduction

It's human nature to dive head first into an exciting new

opportunity – a new relationship, career or purchase. The same approach often applies to joint ventures. The parties quickly enter into the enterprise, filled with enthusiasm for the amazing opportunities that lie ahead, but fail to adequately plan for the likely challenges. In a joint venture, the board members of the joint venture often experience firsthand the negative impact of such poor planning. For example, let's suppose two entities (each, a "JV Partner") enter into a joint venture by forming a new corporation, and each of the entities appoints half of the directors of the new corporation. In this common scenario, directors often view their role on the joint venture board as representing the JV Partner who appointed them, when in fact the directors instead owe fiduciary duties to the joint venture entity. When the interests of the joint venture diverge from the interests of the appointing JV Partner, the directors of the joint venture often face conflicts of interest without readily apparent solutions. This article (i) describes the fiduciary duties to which joint venture directors are bound, (ii) provides examples of the conflicts often faced by joint venture directors, and (iii) offers five strategies to mitigate or

eliminate the conflict of interest dilemmas encountered by joint venture directors.

### Fiduciary Duties of Joint Venture Directors

Delaware has developed an expansive body of case law regarding the fiduciary duties of corporate directors, including the duties of care, loyalty and good faith. The duty of loyalty requires directors of a corporation to make decisions in the best interests of the corporation.<sup>2</sup> Accordingly, if a joint venture is formed as a corporation, the directors must act in the best interests of the joint venture, rather than in self-interest or in the interests of the JV Partner which appointed him or her. The duty of loyalty owed by a director cannot be eliminated if the joint venture is organized as a corporation.<sup>3</sup> This inherently creates a practical problem because many directors of joint ventures and the JV Partners who appoint them expect such directors to solely promote the interests of the appointing JV Partner.

### Conflicts Experienced by Joint Venture Directors

Directors of a joint venture may encounter conflict of interest scenarios in a wide variety of situations. For example, a commonly encountered conflict of interest situation occurs when an opportunity exists for the joint venture to enter into a business arrangement or transaction with one of its JV Partners outside the scope of the existing joint venture arrangement. If the proposed arrangement or transaction is unlikely to be mutually beneficial (i.e. likely to benefit either the

joint venture or the applicable JV Partner, but not both), then a joint venture director who was appointed by a certain JV Partner will experience a conflict of interest. Conflicts of interest are also common when new business opportunities are presented (such as opportunities to conduct business with new counterparties, expand a product line, or create a larger geographic footprint), and both the joint venture and a JV Partner want to take advantage of a new opportunity, to the exclusion of the other. In such a situation, a joint venture director who was appointed by the applicable JV Partner will be conflicted. Finally, a director may have certain information but be unsure regarding whether to disclose such information to the joint venture or the JV Partner who appointed him or her, especially if disclosure likely would benefit only the joint venture and not the applicable JV Partner, or vice versa.

### Five Strategies to Mitigate Conflicts of Interest

Given the likelihood that joint venture board members who are appointed by a JV Partner will experience conflict of interest dilemmas, it is imperative that parties give extensive consideration to this quandary at the outset when determining how to optimally structure the joint venture. As an essential corollary, it is likewise important that the provisions included in the joint venture's governing documents are carefully crafted to address potential conflict situations. To that end, the remainder of this article describes five strategies to mitigate or

eliminate the conflict of interest dilemmas encountered by joint venture directors.

### **1: Form a Contractual Joint Venture, Not a New Entity**

Although many joint ventures are formed by creating a new entity, it is also possible to create a contractual joint venture. A contractual joint venture does not require forming a new entity but rather is created solely by contract, which gives the JV Partners significant freedom of contract to agree upon mutually acceptable terms. For example, in deciding the governance structure for the joint venture, the JV Partners may decide to omit a management committee or its equivalent altogether. Alternatively, the JV Partners may appoint a management committee, but the joint venture agreement may include language stating that the management committee members will solely represent the interests of the appointing JV Partner.

### **2: Elect to be Treated as a Close Corporation**

If the potential JV Partners desire to form a new corporation as the vehicle for carrying out a joint venture, they should consider structuring the joint venture entity as a close corporation under Section 343 of the Delaware General Corporation Law (the “DGCL”). Specifically, the DGCL states that a close corporation may be managed by its shareholders rather than by a board of directors.<sup>4</sup> If shareholder management is preferable or feasible, a close corporation structure may be a good fit for a joint venture, especially given that many joint ventures will already meet the other statutory requirements to qualify as a close corporation, such as having less than thirty shareholders and imposing certain restrictions on stock transfers.<sup>5</sup>

### **3: Form the Joint Venture as an LLC**

For potential JV Partners seeking to establish a joint venture by creating a new entity which will be governed by a board, forming a limited liability company is a viable option. As compared to corporations, limited liability companies (“LLCs”) are largely creatures of contract.<sup>6</sup> Consequently, JV Partners have much

greater flexibility in setting forth what, if any, fiduciary duties will bind the board members of a joint venture which is formed as an LLC. Importantly, in 2004 the Delaware General Assembly passed legislation which permits JV Partners to expand, restrict, or eliminate the fiduciary duties which bind the board members of an LLC (except the implied contractual covenant of good faith and fair dealing).<sup>7</sup> If a Delaware LLC’s organizational documents are silent with respect to fiduciary duties, however, its board members will be bound by fiduciary duties.<sup>8</sup> Therefore, if JV Partners desire to reduce or remove the fiduciary duties of board members, express language to that effect must be included in the operating agreement of the joint venture LLC. Given that subtle nuances in language can have a significant impact on the scope of board members’ fiduciary duties to a joint venture LLC, legal counsel should be consulted in connection with drafting such language for inclusion in a joint venture LLC’s operating agreement.

### **4: Consider Adding An Independent Director**

A further option which can mitigate conflicts of interest among joint venture board members includes appointing one or more independent directors to the joint venture board. Appointment of independent board members, coupled with guidelines which enable board members to identify potential conflicts of interest and abstain from related votes (or other procedures setting forth appropriate actions to be taken in a conflict of interest scenario), can serve as helpful tools in combating uncertainty regarding how to appropriately handle conflict of interest situations. Appointment of independent directors often also has added benefits, such as reducing the potential for deadlock on the board and providing a unique perspective which is distinctive from that of board members appointed by one of the JV Partners.

### **5: Indemnify the Directors**

Each JV Partner who appoints board members to a joint venture entity may take an additional step in mitigating the conflict of interest dilemmas faced by

such board members. Specifically, each JV Partner can indemnify the joint venture board members who are appointed by such JV Partner. Such indemnification does not eliminate the conflict of interest situations described in this article, but indemnification does shift the burden of liability from individual board members to the appointing JV Partner. As such, indemnification is not a complete solution but rather serves as one weapon in the arsenal when developing a comprehensive plan to address the conflict of interest dilemmas experienced by joint venture board members.

### **Conclusion**

In summary, proactive planning is the key to effectively reducing or eliminating conflicts of interest faced by joint venture board members. By considering the strategies above and consulting with legal counsel regarding additional or alternative strategies which may be appropriate in a given joint venture situation, potential JV Partners will minimize conflict of interest situations, thereby enabling joint venture board members to focus on the other vital aspects of service on a joint venture board.

*The content of this article has been prepared for informational purposes only and does not constitute legal advice.*

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<sup>2</sup> See e.g. *Teamsters Union 25 Health Services & Insurance Plan v. Baiera*, 119 A.3d 44, at 63 (2015).

<sup>3</sup> Del. Code. Ann. tit 8, §102(b)(7)(i).

<sup>4</sup> Del. Code. Ann. tit 8, §351.

<sup>5</sup> Del. Code. Ann. tit 8, §342.

<sup>6</sup> Del. Code. Ann. tit 6, §18-1101(b).

<sup>7</sup> Del. Code. Ann. tit 6, §18-1101(c).

<sup>8</sup> Del. Code. Ann. tit 6, §18-1104.