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An Alternative to Mergers and Acquisitions (M&A) – Pre-Sale Joint Venture As First Step of a Staged Sale

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At times when funding may not be available or general economic uncertainty may otherwise preclude a M&A transaction from being completed, it is worth contemplating a pre-sale joint venture as a viable alternative. The advantages are clear. For the ultimate seller, it can be the first step toward a full exit. For the ultimate buyer, it provides a unique opportunity for a particularly thorough due diligence and valuation exercise. While a pre-sale joint venture is not easily implemented, under certain circumstances the mix of assets, goodwill and/or know-how contributed by both parties may be more attractive, and the joint venture may be easier to accomplish, than identifying a party with the wherewithal or willingness to complete a traditional M&A transaction. Cash will of course eventually change hands at the sale stage when the purpose of the joint venture has been fulfilled and one party purchases the joint venture from the other party.

While this type or "pre-sale joint venture" has many similarities to a more typical joint venture formed for an operating business purpose, there are some important differences. For starters, while the lifespan of many joint ventures may be shorter than the parties might expect at the outset, the pre-sale joint venture version is short-lived by definition. Governance and conflict resolution remain very important issues to consider and negotiate, but given that the eventual sale is a main driver rather than a distant or remote possibility, the exit plan is key to the parties, but preparing the exit upfront can lead to tough negotiations.

Joint venture exit mechanisms are legendary both for their dramatic names and their unpredictability – "shootouts," "standoffs" and "Russian roulettes." If from the very beginning the parties intend to separate from the joint venture, the best advice may be to opt for an unassumingly named but efficient combination of put and call options, which gives both joint venture partners a guaranteed right to buy or sell according to their long-term strategies. Obviously, to be able to implement such a structure, there must be a clear understanding as to how the acquiring partner will fund the other partner's exit, and importantly how the buyout price will be determined.

There are a number of ways to price such a transaction. For example, a formula may be used to determine value if the options are exercisable within a fixed time period or the parties may elect to base the price on market value or the net asset value, which may be determined by a third party appraisal or otherwise. Whatever the method, it is crucial that the joint venture agreement sets out a clear and detailed mechanism for determining price, including such items as calculation methods, reference dates, roles and identity of experts and many more.

Maybe more than any other business combination, joint ventures are risky and uncertain despite negotiating the most detailed provisions in the joint venture agreement. But one question each party will have to answer is whether they want a risky and uncertain deal or no deal at all.

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