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Industry Update

The Joint Venture MOU Trap: Why Early Legal Advice Matters

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In the context of forming a joint venture or consortium, a memorandum of understanding (MOU) (also referred to as a term sheet, letter of intent or, in an auction context, a joint bidding agreement) is a formal, pre-deal document that sets out the key commercial terms of a transaction. It is often negotiated early by investment professionals, sometimes with in-house legal support but generally before external counsel is appointed. Although it typically contains a mix of binding and non-binding provisions, it is often treated as largely non-binding and therefore given limited scrutiny, which can create material risk.

That assumption is precisely what makes MOUs high-risk, as binding provisions can have significant consequences, while the non-binding provisions generally form the basis of the shareholders' agreement and are difficult to unwind later. This risk is particularly acute in early-stage joint venture or consortium bids, where parties move quickly with minimal documentation and a limited legal budget, before due diligence or final investment committee approval. However, MOUs contain "commercially binding" terms on the issues that go to value, effectively shaping the shareholders' agreement, in addition to certain key binding provisions (such as the bid decision-making process, cost sharing and exclusivity). This raises important legal and commercial issues that warrant early, focused legal input.

Typical Binding Provisions

Bid Governance/Decision-Making Process and Withdrawal Rights

Typical binding provisions include the bid governance or decision-making process, which outlines the parties' intended approach to the bid, including how the bid will be approved by the parties. Decisions regarding the bid, such as price increases, are usually subject to unanimity to protect the parties' interests. The bid governance framework may also provide for "kick-out" rights, allowing one or more parties to exclude the other from the bidding process in specific circumstances, such as a failure to agree on key bid terms. The parties will also have the right to withdraw from the consortium at any stage, subject to the usual legally binding terms, such as exclusivity, cost sharing and confidentiality, as detailed below.

Exclusivity

Exclusivity arrangements should, where possible, be limited so as not to prohibit an investor from engaging in discussions with, or attracting, co-investors, or otherwise restrict the investor's ordinary course business activities. Also, in many cases, if a "kick-out" or withdrawal right is triggered in a multiparty consortium, the "kicked out" or withdrawing party should continue to be bound by exclusivity, while the remaining parties should be free to attract new investors to join their consortium.

Cost Sharing

The potential consequences of agreeing to certain binding cost sharing obligations should be carefully considered. For instance, while the approach to cost sharing will differ depending on the transaction, if the parties are forming a consortium, costs are commonly split in proportion to their proposed equity stakes, and any bid budget is usually agreed upfront and attached to the MOU. Where a party withdraws from the process, it is market practice for that party to remain liable only for its pro rata share of the costs incurred up to (and including) the date of withdrawal, subject to any express agreement to the contrary (e.g. the inclusion of any break fees).

Confidentiality

In relation to confidentiality terms, such clauses typically include standard carve-outs consistent with the applicable non-disclosure agreement, including for disclosure to affiliates, co-investors, LPs and professional advisers, in each case on a need-to-know basis and subject to customary confidentiality obligations, as relevant.

Typical Non-Binding Provisions

Bid Mechanism and Preliminary Deal Structure

The MOU will outline key non-binding provisions, including the bid mechanism and preliminary deal structure. The bid mechanism explains how the parties plan to participate in and submit a bid. The preliminary deal structure covers both the acquisition and the joint venture, setting out the proposed form of the transaction (such as a tender offer or a negotiated share acquisition) and the high-level allocation of roles and responsibilities. This provides the parties with early alignment while deferring detailed, legally binding commitments to the shareholders' agreement.

Shareholders' Agreement Blueprint

The other non-binding provisions in an MOU set out the commercial understanding of the principal terms of the venture, serving as the blueprint for the shareholders' agreement. Such terms related to the joint venture are often appended in a separate term sheet and will usually outline details relating to the governance and management framework, capital and funding, decision-making and control, share transfer provisions, termination and exit mechanisms, and other key provisions that will be heavily relied upon in later negotiations.

Governance Framework

Governance matters should be approached with a view to drafting the final shareholders' agreement and, accordingly, it is important to get the main commercial terms right early on. Governance provisions will include details concerning board composition and appointment rights, the chair and casting vote, quorum requirements, reserved matters (i.e. decisions that cannot be taken without the prior approval of specified shareholders), and the delegation of authority to management or committees.

Exit Mechanism

Exit arrangements are commonly addressed on a non-binding basis through indicative routes such as trade sales or IPOs, together with expected liquidity timelines as well as pre-emption mechanics. It is important to be clear on whether there will be any lock-up period, drag or tag rights, as well as any rights of first offer or refusal applying to share transfers, whether direct or indirect (including change of control considerations). It is not enough to simply include reference to "standard pre-emption terms" as there are significant differences between these types of rights (such as a ROFO vs ROFR). A brief paragraph setting out certain key details for such rights will therefore go a long way in ensuring reduced scope for debate later as to what was in fact agreed at the MOU stage.

Final Thoughts

MOUs are the foundational documents in joint ventures and early legal input is essential to navigating the legal and commercial risks. It is crucial to strike the right balance to ensure the MOU is sufficiently high level to enable the parties to progress quickly to the next stage of the deal yet detailed enough to make sure there is a meeting of the minds on the main commercial points that go to value.

We are routinely approached by clients to help with early stage and pre-deal structuring discussions and documents (such as MOUs, term sheets and joint bidding agreements) before deal counsel is formally engaged and the deal is fully crystallised. This enables our clients to focus on key structural considerations early on and build a solid foundation for the formal transaction phase. For advice or guidance in relation to joint venture MOUs, please contact a member of our team.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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