Guest Article

Joint Ventures: A Primer

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A company that excels at manufacturing one kind of product might not be well positioned to manufacture another product in a different but related line. Significant customers of another manufacturer may want additional products that would take many months in research, development, and building out of new facilities. One company may have outclassed its competitors with its distribution channels, but isn't quite as strong in its product research and development. Another company may have developed the industry-leading brand, and want to devote its resources to developing that brand rather than running its manufacturing facilities. One manufacturer has decades of developing its North American market, but has virtually no experience in targeted overseas markets.

These are just a few reasons companies form joint ventures and other strategic alliances as a method of value creation. Not every company is the best at everything.

The most successful joint venture participants are the ones who are willing to ask the uncomfortable questions up front. What management and information controls will I have? Who is responsible if things go wrong? How will damages be measured if my joint venture partner fails to meet its obligations? What is my exit strategy? Companies that enter into joint ventures are wise to do so with eyes wide open.

Definition and Purpose of a Joint Venture

The term "joint venture" means different things to different people. In addition, its definition can vary depending on what part of the world the participant is located. One common theme is that a joint venture involves a business enterprise entered into for profit by two or more people, for a limited time or limited purpose.

Ironically, the term "joint venture" by itself has a very limited legal significance in the United States. For example, there is no particular type of legal entity known as a "joint venture." However, this is not necessarily true in other countries. The culture and legal framework of many countries place a special significance on relationships that are labeled as joint ventures.

There are a multitude of reasons businesses might want to form a joint venture, such as:

- Leveraging a strong brand by distributing products in a new market
- Taking advantage of manufacturing capabilities and efficiencies
- Combining purchasing power to source and purchase raw materials
- Utilizing and sharing excess manufacturing capacity

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- Monetizing a breakthrough in manufacturing technology that would provide an advantage to owners of relevant recipes
- Utilizing a robust research department to further develop a product first developed by a potential partner

Legal Issues in the Initial Joint Venture Discussions and Negotiations

Preliminary Confidentiality Agreement

Often, meaningful discussions among potential joint venturers can't even begin without the parties having to share confidential information. There are many reasons for a joint venturer to want to protect its confidential information at the earliest stage possible, such as the protection of technology, processes, and know-how from the other party, who is occasionally a competitor. Due to the difficulties in enforcing confidentiality agreements, the parties might find it worthwhile to withhold critical confidential information until the joint venture is on the brink of closing. This must be carefully balanced against the trust that is essential to a successful joint venture.

Letter of Intent

The execution of a letter of intent (sometimes styled as a memorandum of understanding, term sheet, protocol, summary of terms, or other titles) is the first major undertaking of negotiating a successful joint venture. While not a strict requirement, joint ventures can take a long time to structure and negotiate. The legal agreements documenting the venture can become very expensive and complex. It is usually more efficient and economical for the parties to agree to the main commercial terms in a non-binding letter before detailed negotiation takes place. If any of the key points of a potential relationship may be controversial, it is most economical to flesh those issues out as early in the process as possible. A good rule of thumb is that a letter of intent includes those material and contentions points that could seriously derail negotiations if they were first discussed at a later stage of the process.

Customarily, letters of intent are not intended to be legally binding – with the exception of certain clauses (such as confidentiality). Even though the letter is not legally binding, it will have moral force in negotiating the final legal agreements. Even though a letter of intent is largely non-binding, it is important to note that, in the U.S. and many other jurisdictions, the parties have a duty to negotiate in good faith. The letters of intent will provide evidence of the close relationship between the parties and their expectations.

Antitrust Issues with Joint Ventures

Most developed countries contain some laws or regulations intended to promote or maintain market competition by regulating anti-competitive conduct and unfair business practices. For historic reasons, these are generally referred to as antitrust laws in the United States, although other countries usually refer to such laws by other names.

When prospective joint ventures begin discussions regarding potential collaborations, especially when those parties are or could be competitors, it is important to consider substantive antitrust risks early in the process, as these risks can materially affect the limitations of the joint venture relationship itself. As such, antitrust concerns are threshold issues.

Many jurisdictions require filing for governmental clearance, either before a joint venture can be consummated, or soon thereafter. In the United States, the Hart-Scott-Rodino Antitrust Improvement Act of 1976 requires filing when a joint venture has certain characteristics. The filing thresholds are indexed for inflation. As of 2011, all joint venture transactions of $263.8 million or more require a filing. In addition, all transactions between $66 million and $263.8 require a filing if one of the parties is worth at least $13.2 million, the other is worth at least $131.9 million, and the total amount of assets now owned by the joint venture reaches $263.8 million. It is of critical importance to note that, even if no governmental clearance is required, the parties must determine whether the joint venture or its activities will be considered unlawful under antitrust law.

Structuring a Joint Venture

Legal Entity or Relationship

As previously described, the term "joint venture" by itself can mean many things. Similarly, the legal structure of a joint venture can take one of several different forms. A joint venture can be:

- A contractual relationship not constituting a separate legal entity
- A general partnership
- A limited partnership
- A limited liability company
- A corporation
- Another entity created under a non-U.S. jurisdiction

In addition to the legal entity (or lack thereof) that will form the basis for the parties' arrangement, it may be advantageous to create additional entities to serve specific tax or liability protection purposes. Furthermore, often a joint venture entity will enter into one or more agreements with one of its joint venture members, such as leases, supply agreements, intellectual property licenses, and

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product purchase agreements. The existence of these separate agreements should be considered part of the overall "structure" as much as the creation of separate legal entities. Generally, a joint venture arrangement will contain a master "joint venture formation agreement" or other document that ties all of the entity formation and separate agreements together.

Capital Contributions

Depending on the purpose of a joint venture, it will be necessary for the venturers to contribute cash, equipment, intellectual property, real property, machinery, expertise, personnel, or services. It is of critical importance that the joint venture agreement (in whatever form) address the following issues:

- **Initial capital contributions.** The parties need to agree what each will contribute to the joint venture. When a joint venturer contributes a piece of equipment to the joint venture, the parties may negotiate that the particular piece of equipment be returned to the contributing party at the termination of the joint venture.
- **Capital calls.** The parties should anticipate that the joint venture may need additional capital at some point during its existence. Therefore, it is of critical concern who makes the determination that additional capital is necessary, who will be required to make the contributions and in what proportion, and how long the parties have to make the contribution. Where only one party is required to make capital contributions, it may be prudent to provide a priority or higher return with respect to that capital as a method to disincentivize to make additional capital calls.
- **Consequences of a failure to meet capital calls.** Circumstances change over the life of a joint venture, and a party that may be required to make a subsequent capital contribution may be unable to do so when called upon. The parties should anticipate that possibility and provide for interim measures (short of terminating the joint venture) that permit the joint venture to seek the required capital from other sources at the expense of the defaulting member.

Distributions

The parties to a joint venture need to determine when to distribute profits from a joint venture. One complexity, however, is that distributions are often not simply pro-rata. Rather, distributions may have varying levels of priority. The parties should agree at the onset of how frequently to make distributions, and what level of reserves would be appropriate to keep with the joint venture.

Representations, Warranties, and Covenants

Joint venture parties generally agree to enter into arrangement only upon the assumption that certain facts are correct. As a result, it is common that each party make representations and warranties to the other that, if untrue, would cause that party to be in breach of the joint venture agreement, and liable for damages. Some examples of common representations and warranties are that:

- Each party is authorized to enter into the joint venture, without violating any other agreement
- Each party has delivered accurate financial statements to the other
- Each party has full legal title to the property to be utilized by the joint venture
- Neither party is aware of any outstanding required government authority, environmental liabilities, or court order that would adversely affect the business of the joint venture

In addition, the parties to the joint venture agreement make certain covenants or promises to do things. If the party does not perform or comply with the covenants, that party would be in breach of the joint venture agreement, and liable for damages. The representations, warranties, and covenants may become very extensive and are generally heavily negotiated points, since their breach (even unintentional) can lead to liability for damages.

Operating a Joint Venture

Management of the Joint Venture

A joint venture that is formed by one or more legal entities needs to decide who will have the power to manage the venture. Often, the parties will agree to a board of directors or similar body consisting of members from each venture partner. Where the number of members of the board from each party is equal, however, a deadlock is possible, and the parties may wish to consider one of several ways to break a deadlock.

While board oversight is a critical concern, the day-to-day operations of the venture will usually be the responsibility of one or more officers or managers. The parties should determine whether these individuals will be employees of the joint venture, and who will make the decision to hire, terminate, or replace each. If the managers will remain in the employ of one of the parties, the joint venture agreement should provide a mechanism for the joint venture to reimburse or otherwise give that party credit for the services provided to the joint venture.

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Reporting and Accounting

Each party to a joint venture should be regularly apprised of the financial condition of the venture. This is generally accomplished through the distribution of regular financial statements. Furthermore, joint ventures may require the parties to approve a budget for the joint venture at the beginning of each year. The parties should agree, up front, to the frequency of these financial reports, the standard of accounting (i.e., U.S. generally accepted accounting principles ("GAAP") or some other standard), and the currency in which such reports shall be prepared. The discussion and reporting in one or more currencies may act to highlight the risks of currency fluctuation by the joint venture.

Confidentiality, Notice, and Non-Competition

Parties to joint ventures often agree to keep most information relating to the joint venture confidential. However, in certain cases involving a publicly traded company, the existence and certain information relating to the joint venture must be publicly disseminated. In addition, one of the parties may place a high value on announcing the formation of the joint venture. In that event, each party should agree on the form of the press release or other announcement.

Related to confidentiality, each party may have an obligation to notify the other of the existence of certain significant conditions, such as litigation, market development, or other business opportunities. The joint venture agreement should include a provision requiring such notice.

Finally, the parties usually agree that they will not directly compete with the business of the joint venture. In addition, oftentimes, one of the reasons for entering into the joint venture might be to prevent (either explicitly or implicitly) a joint venture partner from entering the market of the other. In those situations, the antitrust concerns described above should be thoroughly considered.

Tax Consequences of a Joint Venture Relationship

The tax consequences of a joint venture relationship are various and fact intensive, so a detailed description is necessarily beyond the scope of this discussion. However, the parties should seek appropriate counsel to wade through the many levels and types of taxes that a joint venture could encounter, including:

- U.S. and foreign income taxes, including the applicability of any income tax treaties, and the treatment of each relevant joint venture entity by the different jurisdictions
- U.S. state and local taxes, including sales and use taxes
- Property taxes
- Excise taxes levied on the manufacture of certain products
- Non-U.S. value-added taxes ("VAT") and credits accruing therefrom

Exit Strategies

Perhaps the most important decision regarding a joint venture involves the means upon which it will terminate. Each party should thoroughly analyze all of the possible outcomes of a joint venture, and map out the consequences of each. For example, joint ventures often terminate at a certain point in time, but are subject to automatic or optional renewal periods. Joint venture agreements often contain clauses that permit either party to terminate the venture upon a certain level of advance notice, under the theory that the joint venture must be mutually beneficial at all periods of time in order to be successful. In other circumstances, if one party causes a significant breach of one of the joint venture agreements, the non-breaching party could seek to terminate the joint venture. In addition, a government or other regulatory action could frustrate the purpose of the joint venture that could trigger termination. Finally, a force majeure or other act of God could cause the termination of the joint venture relationship. In each case, the parties should consider the consequences, including:

- Whether the termination of the joint venture is automatic or whether one or both parties has an option to terminate the joint venture
- Whether the termination gives rise to a damage claim by the party not causing the termination
- Whether the termination could give rise to an obligation or option by one party to purchase the other party's interest in the joint venture

Disputes, Resolution, and Damages

Much time is unfortunately spent in negotiating for the possibility of a joint venture's failure. When a dispute arises, however, it is to the parties' advantage to know how such disputes will be resolved. Of relevance to that determination is whether the dispute will be resolved in litigation or arbitration. In either case, the parties should agree where such litigation or arbitration would take place. Finally, in the event that one of the venturers is a foreign entity, the U.S. party should be comfortable of its ability to enforce the judgment (in the case of litigation) or arbitral award (in the case of arbitration) in the foreign jurisdiction. If one party is a multi-national conglomerate, the other party should understand which legal entity is its partner and whether any enforcement would be beneficial. For example, if the multi-national conglomerate's joint venture entity is a special purpose entity, a damage award against it would be of little use without a guarantee of performance by the holding company or another company with significant assets.

The measure of damages is also of critical importance. Parties to a joint venture will often try to limit their exposure upon its breach of the joint venture agreement by disclaiming any liability for the other party's lost profits, or consequential damages. The parties should have a clear understanding of the constraints of how damages will be measured in the event of their or their partner's breach.

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Joint ventures do not generally fail because of an inferior product, business plan, or flaw in the general principles. Rather, joint ventures fail for lack of the parties negotiating at the onset to their expectations. The negotiation process is also useful not just to agree on the salient terms and conditions of the venture itself, but to give each side a feel for the culture and business functions of the other and gain an understanding of what it would mean for the two businesses to develop a relationship. The negotiation of a joint venture relationship involves each party's balancing of 1) the protection of its interests and getting the best deal it can, 2) the appeasement of a potential future partner, and 3) the determination of how difficult a working relationship with the partner is likely to be. The greater effort that the parties and their advisors are willing to exert prior to the joint venture's formation, the more likely they are to have a profitable and sustainable relationship.

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