

Joint Ventures in Food: Tasty Opportunities

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A FREEBORN & PETERS FOOD INDUSTRY TEAM WHITE PAPER

ABOUT THIS WHITE PAPER:

A joint venture can be a powerful means for food companies to reduce costs, increase revenues and share risk. But, if not structured properly, a joint venture can easily fail to fulfill the objectives of those involved. This White Paper examines why companies might choose to form a joint venture and explains the many available alternative forms. It also describes specific steps often used to maximize the likelihood of success.

Tom Dowling had been a long-time client of mine but when he came to my office the other day, he had a different look on his face. I knew he had something weighty on his mind but wasn't sure quite how to ask him about it. I didn't have to. When he sat down, he started talking right away. *"Brian, you know we've been having a great run with the company and you've been a great help along the way. But now I feel we may have tapped out our growth and frankly I'm concerned. I've spent the last 25 years growing the business and now I'm thinking maybe we've gone as far as we can."* Tom paused and looked out the window. *"Brian, can you help me brainstorm on this one?"* I nodded.

Tom's company Dowling Foods specialized in botanical extracts and specialty food ingredients, and had recently opened several new facilities, which had been no small feat logistically or legally. When Tom began the company nearly 30 years ago, it had been a small specialty ingredients supplier. Both its product lines and revenues had grown incrementally. With the national distribution network in place, Dowling Foods was growing rapidly. But that was exactly Tom's concern: Where would its future growth come from? Should the company look toward new acquisitions or did it make more sense to seek out additional capital?



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As a corporate-transactional lawyer with a deep background in tax, I knew that Tom’s concerns were common. Business owners and executives struggle with the most effective ways to keep their organizations relevant and growing. When a business owner meets with his or her lawyer, there is a temptation to simply provide a laundry list of growth ideas and opportunities rather than explore what was really driving concerns. Knowing Tom, I knew that he would welcome some ideas to move our discussion along.

“Tom, I can appreciate where you are coming from. We’ve explored a number of ideas over the years. Are you thinking we should go over some of those?” I inquired. “That might just help,” he said and my hunch was confirmed.

“Well, some of the things we’ve discussed in the past include opening more locations and taking a look into franchising your business. We’ve also taken a look at licensing your products, expanding into other markets and of course, strategic partnerships, or what are commonly called joint ventures.” I made the mistake of taking a breath and that’s when Tom interrupted.

“Yes, yes that’s what we talked about. Let’s get back to that idea on joint ventures or partnerships or whatever you called it. It’s what the company needs to do,” Tom said with such force that I knew he had now found his answer. “With the success we’ve had in our products, I know we can expand our offerings to other countries. The question is how and I think a joint venture is the way to go,” Tom continued.

“Well, Tom, you are savvy enough to know that a joint venture is a good way to partner without having to fully commit, or merge. It might be just the thing to explore,” I added, knowing that Tom had already made up his mind and likely had several potential partners in mind. “Just remember, my job is to keep you focused on the details like preparation. More joint ventures fail than you think - not because of bad products - but because people don’t set their expectations at the start.”





As much as Tom wanted to move forward, I took the time to talk with him about preparation and expectations. He did have several joint venture partners in mind – companies and people he had informal relationships with for many years and who might, in fact, be good starting points.

When either looking for or confirming the right joint venture partner, there is no substitute for taking your time. After years of helping businesses enter into joint ventures, I've learned that the process for selecting the right partner includes four important considerations:

1. **Screen** – thorough screening of prospective partners – your initial “right partner” might not check out when an analysis is complete.
2. **Short List** – create a set of prospective partners and create a priority ranking.
3. **Credential Check** – even though many business people think they “know” someone, credential checking and references can help seal the deal or change someone’s mind.
4. **Deal Structure** – there are any number of ways to set up a joint venture (see page 7) and it’s important to know the needs/wants/desires of the potential partner so the right approach can be put in place.

Based on our discussion, Tom targeted Canada as his preferred initial area of expansion and also immediately rejected two potential joint venture partners. “I think they have credit problems and we need a company partner with the same values and stability as us,” he said, adding, “You were right to talk me through this process of choosing a partner. It’s helping me clarify who would be ideal for us.”

I could tell Tom was thinking now. “Brian, I know there are a variety of advantages to having a strategic partner. At our stage, something like this is attractive because it allows us to explore growth relatively quickly and with a lower level of risk than a merge or acquisition,” he said.

“You’re right, Tom. A joint venture also can be a way to achieve economies of scale. Much like an acquisition, the joint venture parties can eliminate duplicative capital and labor to contribute to the overall profitability of operations.”

Tom sighed. “There you go. Talking like a lawyer again. But I guess that’s why I hired you.” We both smiled.

“I like all the advantages to the joint venture but I do think we should talk a little bit about the drawbacks. I know. I know. You can’t believe I’m the one asking about downsides, huh?” Tom said slyly.

Now it was my turn to smile. I had wanted to review the drawbacks but knew I had to wait for the right opening.

“Tom, you are an astute businessman. If you don’t know the downsides, then you aren’t really going into a joint venture with your eyes open,” I said.



Again, I took the time with Tom to talk about the reasons why Dowling Foods might not want to enter into a joint venture. I didn't think Tom would be dissuaded by our discussion. In fact, I knew he wanted to move forward; he just had to do some serious thinking about the right strategic partner.

- **Loss of control.** Food companies entering into a joint venture must be willing to live with some level of reduction of the control over the operations of the joint venture. The level of control allocated among the parties is various, flexible and the subject of important negotiations.



- **Providing a “peek”.** Companies that enter into joint ventures with others in their own industry may be unwittingly providing an adversary with valuable information as to its finances, operations or culture. This “free peek” could come back to haunt the company later.
- **Limitation of options.** Joint venture partners will generally negotiate to prevent each other from competing with the joint venture. In ways that were not anticipated when the joint venture was consummated, these provisions could provide limitations on a joint venturer's ability to expand outside of the joint venture.
- **Profit Sharing.** Just because a joint venture is profitable does not necessarily mean that it was more profitable than one party having “gone it alone.” The advantages of joint ventures come with the price of having to share some level of margin with the joint venture partner.
- **Accountability.** Certain companies may have difficulties in reporting what it once viewed as confidential information with its joint venture partner.



- **Employee focus and loyalty.** Often, a joint venture partners' contributions to a joint venture include the commitment of employees to the joint venture. Irrespective of whether the joint venture is ultimately successful, an employee could find himself switching loyalties from his historic employer to the joint venture and, perhaps ultimately, to the other partner.
- **Hidden Agendas.** At the heart of a joint venture relationship is a level of trust. However, joint venture parties are still independent companies, so they often do not disclose their most important goals with the joint venture.
- **Cultural Differences.** While it may not be apparent in the consummation of the joint venture, the parties' cultural differences (both from a geographic and business practices sense) may become a significant obstacle to a successful joint venture. Given Tom's desire to joint venture with a Canadian company, I didn't think there would be much of a problem here but I raised the issue nevertheless.

Our meeting was going long and I could see that Tom was becoming jumpy.

"Tom, we still have a lot to discuss. We should talk about capital contributions, issues of control, tax consequences and a few other things. How are you holding up?" I asked.

"Well, I'm sort of at my meeting limit, Brian. Believe it or not, I do want to discuss all these things but only after we get closer on our joint venture partner. I need to talk internally to my management team as well and get their feedback," Tom said.

"We're at a preliminary stage." I agreed. "Tom, how about we schedule another meeting after you've spoken to your team. You can let me know if there is any value to me attending that meeting."

"There might be. Let me mull that over. In the interim, can you send me a summary of our meeting today, as well as a list of the considerations we need to go over should this deal get off the ground?"

I smiled. So did Tom. "Of course," I said. More than likely, Tom and I were going to move ahead and get his growth initiative off the ground. There was a lot of work to do.

Structuring the Deal: What Functions Best for Food

“Joint venture” can mean many things. But the structure of the deal is one of the most essential elements of doing it right. The needs of the parties will help identify what is best for everyone, such as:

A contractual relationship not constituting a separate legal entity.

Some joint ventures may take the simple form of a revenue sharing agreement, a lease, a supply agreement or some other agreement not constituting an actual legal entity. Often these structures are best for simple ventures with a very limited purpose and short duration. One potential drawback is that, in certain jurisdictions, depending on the extent of the parties’ relationship, a court could impose partnership duties on the parties, despite the parties exclaiming any partnership relationship.

A general partnership. The parties may agree to create an unincorporated association to operate a business as co-owners. One advantage of this approach, in the United States, is that no governmental filing is required for a general partnership. However, unlike some of the other legal entities described below, the partners of a general partnership are not afforded the luxury of limited liability.

A limited partnership. A limited partnership is a partnership with at least one limited partner and one general partner. A limited partnership is formed by filing a certificate of limited partnership with the appropriate governmental agency. While the general partner of a limited partnership is liable to creditors of the partnership, the limited partners are not. The use of limited partnerships have given way to the newer, but more flexible limited liability company (see below) for ventures where the parties and the operations are solely in the United States. However, foreign countries’ tax treatment of U.S. limited partnerships may be more beneficial or certain than that of limited liability companies. As a result, limited partnerships are still relevant in the international context.

A limited liability company. For the last decade or so, the most common legal entity in the United States for forming a joint venture is a limited liability company (“LLC”). An LLC is an unincorporated organization formed by filing a certificate of formation or articles of organization under a state limited liability company act. None of the members of an LLC is liable to a third party for the obligations of the LLC solely by reason of being a member. The true advantage of an LLC in the joint venture context is its flexibility. State laws generally permit joint venturers to agree on whatever provisions they desire within the context of an LLC governing document (i.e., the operating agreement.)

A corporation. In some circumstances, the parties may create a separate corporation to own and operate the joint venture. A corporation, owned by its stockholders and managed by its board of directors, is a concept that is familiar to businesses in even the least developed areas of the world. As a result, forming a corporation may be the path of least resistance when forming a joint venture with an international partner who is relatively inexperienced in dealing with U.S. legal entities.

Another entity created under a non-U.S. jurisdiction. In situations where the joint venture will operate primarily in a foreign jurisdiction, it may be prudent that the joint venture vehicle itself be an entity created in that foreign jurisdiction. Alternatively, joint venturers often create the joint venture vehicle in the U. S. (through, for example, an LLC), which in turn owns 100% of a foreign entity that houses the substantive operations of the venture.

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 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. Often, 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.



Now that you want to go joint venture...

1. **What are the joint venture's capital needs?** Depending on the joint venture's purpose, there may be needs to contribute various forms of capital to it, from cash to equipment, real property to expertise. The parties need to determine their initial capital contributions and then think about issues such as future capital calls. Envisioning these capital needs at the outset helps keep everyone's expectations in line.
2. **Who controls the joint venture?** The parties to a joint venture need to decide who will have the power to manage the venture. Often, they will agree to a board of directors or similar body consisting of an equal number of members from each side. They also need to discuss the venture's day-to-day operational structure and management. How and when will the joint venture make profit distributions?
3. **Are there any antitrust impediments?** Antitrust concerns are threshold issues, particularly if the parties are or could be competitors. 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.
4. **What are the joint venture's tax consequences?** In almost every situation, the tax consequences are various and fact intensive and may include U.S. and foreign income taxes, U.S. state and local taxes (including sales and use taxes), property taxes, excise taxes on certain products (most notably alcoholic beverages) and a variety of non-U.S. taxes, such as value-added taxes (VAT).
5. **What are my exit strategies?** Perhaps the most important joint venture decision involves the means upon which it will terminate. For example, joint ventures often terminate at a certain point in time but are subject to automatic or optional renewal periods. The parties can include clauses to permit termination with advance notice, if a breach occurs, if a government or regulatory action frustrates the venture's purpose, or if the proverbial "act of God" occurs.
6. **If the joint venture doesn't work out, how are disputes measured and resolved?** In addition to this important question, the parties should discuss damages and how they would be measured and assessed.

Seasoned Companies Select Joint Ventures



- Leveraging a strong brand by distributing products in a new market.** McCormick & Company, Inc., a leading manufacturer, marketer and distributor of spices, seasonings, specialty foods and flavors, and Kohinoor Foods Ltd., India, one of the leading manufacturers and marketers of Basmati rice, entered into a joint venture to market and sell basmati rice and other food products in India. The joint venture was intended to leverage McCormick's broad product line with Kohinoor's specific extensive distribution network in the Indian retail market.



- Taking advantage of foreign manufacturing capabilities and efficiencies.** Using economies of scale and efficiencies through foreign manufacturing in the food industry is hardly a new trend. As early as 1984, H.J. Heinz Company set up joint venture enterprises in Guangdong, China with the Yantang Company to produce baby cereals for export.



- Using and sharing excess manufacturing capacity.** In October of 2010, Jack Link's Beef Jerky, the #1 meat snack in the U. S. and fastest growing meat snack manufacturer worldwide, announced a joint venture with JBS, S.A., the world's largest protein producer, to jointly produce beef jerky in two previously underutilized plants owned by JBS in São Paulo, Brazil.

- Combining purchasing power to source and purchase raw materials.** In recent years, some of the largest U.S. and international food chains, food service companies and private label distributors have formed international buying consortia to purchase imported private label food products for the account of their members/partners.



- Monetizing a break-through in manufacturing technology to provide an advantage to owners of relevant recipes.** In 2005, food production giant Archer Daniels Midland Company (ADM) and Matsutani Chemical Industry Co., a Japanese producer of specialty food starches and maltodextrins entered into a joint venture to produce, sell and market the dietary soluble fiber Fibersol-2. The food ingredient was originally developed by Matsutani. The joint venture leverages ADM's global presence for the production, sales and distribution functions.



- Using a robust research department to further develop a product first developed by a potential partner.** Country Life Vitamins, a family owned, New York-based nutritional products manufacturer, formed a joint venture agreement with Kikkoman, a large Japanese-based multinational food conglomerate that manufactures food products, including soy sauce; food seasoning and flavoring; mirin; shōchū; and sake, juice and other beverages; pharmaceuticals; and restaurant management services. The joint venture was created to achieve sales growth to Country Life's network of U.S.-based health food stores by using Kikkoman's research and development capabilities.



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Brian Smith is a Partner in the Corporate Practice Group and a member of the Food Industry Team. Brian counsels clients on issues relating to domestic and cross-border joint venture relationships. His practice focuses on corporate-transactional matters, including joint ventures, fund formation, private equity and mergers & acquisitions. Brian counsels clients on the most effective ways to grow their business using the financial, management control, tax, procedural and other issues involved in structuring and negotiating joint venture arrangements, fund agreements, operating agreements, purchase and sale agreements, and other business relationships. Brian's initiation to joint ventures came by way of his extensive tax experience – before entering private practice, Brian was an attorney with the Office of Chief Counsel for the Internal Revenue Service, where he tried cases on behalf of the federal government. He frequently writes and speaks on matters relating to business and tax issues faced by joint venture parties.

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The Freeborn & Peters Food Industry Team

America's food industry faces many challenges: a rapidly modernizing food safety regime; a complex network of suppliers and buyers with many risks and potential liabilities; stagnant domestic demand and intense price competition.

Our Food Industry Team helps food companies address these challenges. It also guides them as they build towards a better future: protecting investments in brands, innovation and facilities; structuring profitable ventures and M&A transactions; securing new financing; and taking advantage of foreign market opportunities.

The Team's partners bring many years of experience, gained at multiple points in the industry and across different legal disciplines, including regulation, litigation, corporate law and government affairs.

We combine legal know-how with business insight derived from careful attention to clients' needs and an ongoing focus on the food industry's specific opportunities and challenges.

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