The ins and outs of joint ventures

Robert Pritchard

Subject: Competition law

Keywords: Agreements; Joint ventures

In 1983 a U.S. financial journalist predicted:

The thrust to joint ventures, that preference for the bland atmosphere of cooperation over the bracing economic climate of competition, is bound to gather force and become the dominant global trend. Sure as night follows day, it is destined to encompass every area of human endeavour.[1]

This prediction has come true. Over the past decade, joint ventures have proliferated. In large measure, this proliferation has been driven by the unprecedented increase in international trade and foreign direct investment.

There is, however, every reason to question Abelson's explanation of the global trend to joint ventures as cooperation rather than competition. Although the rationale for most joint ventures is to create a competitive advantage and to enhance the competitive strength of the partners, markets, too, are changing and becoming more intensively competitive. And competition laws in most countries outlaw those joint ventures which are substantially anti-competitive.

WHY DO INVESTORS WANT TO GET INTO JOINT VENTURES?

The rationale for joint ventures varies in each case according to the strategic business objectives and capacity of the individual partners, as well as external factors. The external factors which cause investors to consider joint ventures include:

Market access

Joint ventures are often the means of acquiring raw materials, production facilities, technology or know-how. Most often, however, they are the means of expanding into new markets. Market access may, for instance, depend on linking up with established distribution channels or operating under a brand name already well recognised in the market-place. Take the mining industry: the developer of a new mine may find it difficult to negotiate long-term sales in export markets without the assistance of a foreign buyer. Conversely, for a foreign buyer, the difficulty of securing resources from a country with a different culture, different language and different legal system may be too severe. In all of these situations, a joint venture can be the most sensible way for two or more parties to pursue their business objectives.

The challenge of scale

Often, the capital required to enable a new business venture to attain competitive

economies of scale may be so great that an investor may be incapable of proceeding alone. A strong financial partner may be needed.

Unfamiliar jurisdictions

The risks of operating in an unfamiliar jurisdiction, particularly the challenge of coping with political variables, can be daunting. The management of these risks can be enhanced by a joint venture with a compatible local partner who is familiar with local business practices, local political processes, local government procedures, local laws and local customs.

Host country participation policies

The foreign investment policies of many host countries require, or at least favour, a minimum level of local participation. The industry sectors most often affected by these policies are defence, media, telecommunications, banking, aviation, infrastructure services and the energy and natural resources sectors.

In some of the more defensive jurisdictions, foreign investors are required to allocate a preordained minimum share of the joint venture equity to the host government. Such requirements can distort the joint venture structure, although they do not always provide an insuperable obstacle--the foreign investor can easily assess the real rate of return at the establishment stage of the venture. If, however, subsequent inputs of technology, services and capital by each of the partners are not based on impartial, arm's length market-based calculations, the economic equilibrium of the joint venture is likely to become skewed and provide fertile ground for later arguments.

Host country privatisation policies

As countries strive to lift economic efficiency, more and more utilities and state-owned enterprises are being disaggregated and privatised. The privatised enterprises are then expected to compete in a competitive market-place without the benefit of state subsidies. This is occurring on an enormous scale in the energy and telecommunications sectors.

Many governments nevertheless impose artificial limits on foreign participation in privatised enterprises. As a result, the number of strange bedfellows in former state-owned enterprises is rapidly increasing.

WHY DO INVESTORS WANT TO GET OUT OF JOINT VENTURES?

Falling out is really very predictable. Partners with innovative strategies are almost certain to fall out with partners who contribute nothing but money, the right citizenship or the right family connections. Partners whose goals are confined to rates of return and little else become wearisome after a while.

Joint ventures are also likely to fail if what brought the partners together in the beginning, their joint project, is the only glue that holds them together. If the project loses its lustre,

or one of the partners goes through a merger or corporate restructuring, there may be little left in the relationship.

Despite their attractions, joint ventures therefore expose investors to a spectrum of problems which never apply to wholly-owned operations. If the foreign partner has trained the local partner to be its future competitor, this may cause great animosity if the joint venture comes under strain. At that stage, each of the parties may wish to lay claim to the facilities, the intellectual property, the technical or marketing know-how, as well as the employees of the venture. To avoid these problems or to solve them harmoniously, it is helpful to choose one's partner wisely. Ideally, the partners should choose each other first and then find the project together. However, this is not always possible, despite the best of planning.

Even where partners do choose each other wisely, their competitive aspirations may diverge as time goes on. The investment structure they adopt must therefore be flexible enough to facilitate a convergence of interests as well as to accommodate a future divergence of interests.

FLEXIBLE STRUCTURES AND ESCAPE STRATEGIES

It is not easy to get out of a joint venture if the project's bankers regard your continued part in the relationship as a material factor in supporting the project and if they are unwilling to finance the remaining partner. You can find yourself locked in but wanting to escape.

What can lawyers do to anticipate and accommodate predictable divergences of interests between partners? They should recommend flexible structures to their clients in the first place. And they should ensure that each partner has an escape strategy that is likely to keep him contented.

Joint venture structures fall into two most common types:

• incorporated joint ventures (“IJVs”--often called equity joint ventures); and

• unincorporated joint ventures (often called contractual joint ventures).

IJVs have consistent advantages over all other types, especially in coping with breakdowns. IJVs take the form of a company, specifically created for the venture, and incorporated under generally applicable company law. The participants take up shareholdings in proportion to their participation in the venture, and the assets of the venture are vested in the company.

IJVs offer a number of important advantages:

• Familiarity--the participants are usually very familiar with a company structure; in most countries they will have the comfort that the external and internal operations of the company are subject to a legal regime comparable to their home jurisdiction.

• Flexibility--the participants can easily alter the course of the venture by adopting new policies and strategies at the level of the Board of Directors.

• Ease of transfer--it is easy to transfer a participant's interest by simply transferring

shares in the company to a buyer (allied to the ease of transfer, there may also be a tax saving on the transfer of shares compared to the tax on the transfer of land or other assets).

• Ease of financing--the joint venture can readily finance its activities in the same way as any company can. An individual participant can finance its participation by granting to a financier a charge over the shares that the participant holds in the company, without affecting the financing arrangements of the company itself or of other participants. Table 1 summarises the financing advantages and disadvantages of IJVs.

• Breakdown--importantly, if the joint venture breaks down, the participants will be able to apply to the court for dissolution of the company. In some jurisdictions, other more flexible forms of legal relief may be available, such as court-ordered sale of shares.

Table 1: Financing Advantages and Disadvantages of Incorporated Joint Ventures

Advantages	Disadvantages
• There will not be a complex JVA to complicate lending risk	• No participant can use the assets as collateral (unless all agree that the joint venture vehicle should be the borrower)
• It will be possible to contain liability solely with the JV company	
• Security will be available over all venture assets, including inventory and debtors	• There will usually be a need for parent company support (raising issues as to the relative creditworthiness of each parent company and the difficulty for banks of accepting guarantees on a pro rata basis)
• On default it will be relatively easy to:	
-- step in to managerial control and	
-- sell the entire assets of the venture	

Where the applicable regime of company law is inadequate for the purposes the partners have in mind, they can enter into a separate joint venture agreement (“JVA”) with special rules to govern their relationship and with preagreed escape strategies to govern the possible breakdown of their relationship.

Compulsory buy-sell provisions should always be considered. There are lots of variants in this area. My general preference is for mechanisms which avoid the need for third-party valuation and instead force the parties to arrive at commercial solutions. I frequently recommend “Russian roulette” clauses where, for example, one party makes an offer to buy out his partner at a nominated price, giving the partner the election to purchase the offeror's interest at the same pro rata price. If the partner does nothing within a stipulated time, he becomes legally obliged to sell.

Admittedly, a disadvantage of IJVs for international investors may be an inability to arrange the most tax-efficient structure (the ability to do this is usually enhanced if foreign investors can invest through a wholly-owned subsidiary). Lawyers and their clients should, however, be wary of the rigidity of tax-driven joint venture structures.

In my experience, unincorporated, or contractual, joint ventures are best left for ventures of limited scope and finite duration. Examples include:

• Joint bidding agreements--often used in the construction industry, where tenderers bid for a job on the basis that they will apportion the job among themselves, and in the petroleum and mining industries, where tenderers bid for exploration and development rights with the intention that they will jointly exploit them.

• Joint exploration and operating agreements--used mainly in the petroleum and mining industries. These are often farm-in or farm-out agreements, where one party earns an interest in a concession held by another party in exchange for carrying out exploration or development work.

CONCLUSION

Joint ventures are proliferating. One can debate forever the pros and cons of using them. Much depends on the characteristics of the venture itself, what each of the parties wants from each other, and various external factors, such as host government policies.

If the decision is made to embark on a joint venture, how best to structure and manage the joint venture and to deal with future breakdown raises many issues which participants often find it easier to avoid than to confront. Lawyers should help their clients address these issues. They should start by ensuring that the joint venture deals with each of its partners on an impartial, arm's length basis.

Eventually most joint ventures will break down and problems on breakdown will be very difficult to deal with. The participants might have problems in initially financing their joint venture, or working together successfully during times of hardship, but they are rarely as difficult as the problems which can arise on breakdown.

Flexible, unlimited-term IJVs, between compatible partners who know each other well and who agree to make arm's length *pari passu* contributions, are much to be preferred to complex contractual structures, especially between partners which have only recently met each other. If more lawyers and their clients understood this, getting out of joint ventures would be much less costly and painful.

By way of postscript, one of my pet hates is lawyers who seek to accommodate the risks of breakdown merely by inserting an arbitration clause in the documentation. That is like the ostrich sticking its head in the sand.

I.C.C.L.R. 1997, 8(9), 303-306

---

1. Alan Abelson in his column "Up and Down Wall Street", *Barron's Financial Weekly,* February 21, 1983, p. 1.