

INTERNATIONAL JOINT VENTURES, A PRACTICAL APPROACH

As the globalization of world markets continues unabated, American businesses seek to explore and develop capabilities to internationally source or distribute goods, services or intellectual property. The recent economic downturn has only made taking advantage of strategic opportunities through international alliances more appealing. All but the largest companies lack the infrastructure, resources, experience and management strength to enter international markets de novo. Business alliances of various forms allow companies to access the global marketplace more economically and effectively. Legal and regulatory, cultural, language and currency differences make partnering in the form of an international joint venture (IJV) an attractive option.

IJVs are also an effective way to enter a new market quickly. But partnering with, sharing the risks and taking advantage of another firm's local resources and expertise can be a treacherous undertaking without proper planning and understanding. This article summarizes the attributes, advantages and disadvantages of IJVs, and, perhaps more importantly, examines the practical aspects of structuring and operating joint ventures. It will identify common mistakes made by participants in joint ventures and, conversely, provide practical insight in structuring joint ventures, leading to higher probabilities of success.

IJV DEFINED

There is no single legal definition of a "joint venture." The term is best defined by the existence of certain characteristics, understandings and arrangements. An international joint venture is often described as the joining together of two or more business partners from separate jurisdictions to exchange resources, share risks and divide rewards from a joint enterprise. Usually, but not always, one of the partners is physically located in the jurisdiction of the joint venture. An IJV has elements of a partnership, but is typically formed for a defined purpose or specified project, and, therefore, is usually limited in purpose, scope and duration. The contributions of the joint venture partners often differ and tend to be specified based on the capabilities of each partner and the nature of the venture.

Although legal agreements are required to create and sustain international joint ventures, in order to prosper, IJVs must be practical, living and evolving relationships. Continued positive interaction and dialogue between the business decision-makers after the formation of the joint venture is critical. Circumstances change and the management team and the joint venture itself must be capable of changing with them.

AUTHORS

Milton R. Stewart

Partner
Portland
miltstewart@dwt.com

Ryan D. Maughn

Associate
Portland
ryanmaughn@dwt.com

This article is a publication of Davis Wright Tremaine LLP. Our purpose in publishing this is to inform our clients and friends of recent legal developments. It is not intended, nor should it be used, as a substitute for specific legal advice as legal counsel may only be given in response to inquiries regarding particular situations.

LEGAL STRUCTURES AND ATTRIBUTES

The joint venture can be a contractual arrangement between the two joint venture partners in which the basis of the understanding and the governing terms are contained in a written agreement. More commonly today, the parties may create an equity joint venture by forming an entity, owned, in agreed proportions, by the respective parties or specially funded subsidiaries, or by purchasing equity in an existing entity. The new entity can take the form of a limited liability company, a corporation or one of the many other forms of entity available under applicable national, state or local law.

The form of joint venture chosen, whether contractual or equity, typically denotes the level of intensity with which the parties are pursuing the joint venture. The equity joint venture is generally used for closer, longer term collaborations where the level of investment is higher. Equity joint ventures may be more difficult to wind up because, in addition to terminating the contractual agreement, the parties often choose to liquidate the assets held by the entity, and such liquidations can be time-consuming.

Whether an equity joint venture or one based upon contract, the relationship between the joint venture parties should always be governed by a definitive written agreement containing the essential terms governing the overall relationship. The attributes and provisions of such agreements are discussed in more detail later in this article.

In addition to the definitive agreement, the parties may enter into ancillary contractual agreements that address certain specific components of the venture. For instance, the joint venture entity may enter into a distribution agreement with one of the joint venture partners (typically the one located in the host country), and a license agreement with the other joint venture partner for access to intellectual property rights necessary for the venture.

ADVANTAGES AND DISADVANTAGES OF IJVS

Advantages

International joint ventures allow for much faster and less costly access to foreign markets than can be achieved by purchasing an existing company in the jurisdiction or starting a new venture. IJVs provide quick access to channels of distribution, and they provide access for the non-resident partner to knowledge and know-how of the local marketplace, which substantially enhances the probability of success for the venture. The resident partner also often has existing relationships with key suppliers and customers, and proficiency in the local language and customs.

These benefits can be especially critical to a small or medium-sized business that does not have the capital, resources or expertise necessary to pursue the opportunity unless it is able to share the risks and the costs through an alliance such as an international joint venture. IJVs allow the partners to move quickly, cost effectively and with credibility (provided by the reputation of the resident partner) in the local marketplace.

The parties to an IJV can also take advantage of complementary lines of business and synergies that may exist between the two companies.

Disadvantages

An international joint venture can result in a frustrating experience and ultimately a failure if it lacks adequate planning and strategy. Factors such as marketplace developments, technology issues, regulatory uncertainties and economic downturns can be difficult to anticipate and can have a debilitating impact on IJVs.

By their nature (and like all partnerships), profits derived from an IJV are diluted because they are shared. Management issues can arise, in spite of having adequate mechanisms in place to resolve disputes, because of different management philosophies of the partners. The partners also may discover that they do not share expectations and are not flexible enough to change and accommodate the evolving needs of the business.

Joint ventures are often difficult to capitalize as an entity, particularly in respect to debt, because they are finite in their duration and therefore lack permanence. Unless an IJV is adequately capitalized, its debt financing, if available at all, may have to be guaranteed, in whole or in part, by the joint venture partners, which can increase their level of risk in the venture.

Another potential disadvantage of an IJV is the possibility of the creation of a competitor or a potential competitor in the form of one's own joint venture partner. This can, as later discussed, be addressed by non-competition, non-solicitation and confidentiality provisions in the definitive joint venture agreement.

JOINT VENTURE FACTS OF LIFE

While the rate of return from a joint venture can be very high and therefore enticing to prospective partners, approximately 50% of all joint ventures fail. The likelihood of early problems is high; a significant portion of cross-border alliances have considerable financial and operational problems during the first years of operation. Their continued survival and success after "hitting the wall" requires ownership flexibility and long-term support. In fact, flexibility and evolution are the keys to successful international joint ventures. It has been said by more than one commentator that up to half of all joint ventures end up modifying their scope by expanding the proposed business or entering into new businesses not contemplated when the joint venture was formed and the initial agreement signed.

Management autonomy is critical. A joint venture whose management is dominated by either party or whose hands are tied unless both parties agree on operational issues is unlikely to succeed.

Although lawyers tend to abhor 50/50 relationships, the data suggest that 50/50 joint ventures work better than others, perhaps because of the balance of terror and the need for collaboration and cooperation. As a corollary, joint ventures between equally strong partners tend to work better than those between partners of unequal strength. Similarly, ventures between partners with complementary strengths work better than ventures between partners with overlapping strengths and commonalities.

JOINT VENTURE MISTAKES

Oddly enough, a common joint venture mistake often cited by participants in failed joint ventures is "cutting yourself too good a deal." A joint venture is a partnership and, like all partnerships, functions well and rewards the participants best if it is structured as a "win-win" scenario for both partners. The parties should focus on jointly making money from customers instead of from each other as a result of an unbalanced or one-sided venture.

Another commonly cited mistake in joint ventures is the lack of an exit strategy. Although it is difficult at the inception of a partnership to plan for its end, this is essential given that the nature of a joint venture is often to be temporary and finite in duration.

Parties also often cite insufficient planning as a principal cause for failure in IJVs. In the excitement and rush to get the project going or to take advantage of a perceived market opportunity, too few joint venture partners think through the challenges and adopt a definitive strategic and tactical business plan. Even if such a plan is developed, attention must be paid to it as the business opportunity evolves. As mentioned previously, the business plan often requires flexibility as the joint venture develops and encounters the challenges of the market place.

Another common mistake is “negotiating from the ivory tower.” It is critical for those negotiating and structuring the joint venture to communicate with the line and operational managers and technicians who will have to live with the decisions made in structuring the joint venture. Those individuals can often provide valuable input early in the process and save the venture from significant cost and possible failure once underway. Remember, they know things you don’t and can’t know.

Haste is also a commonly mentioned joint venture mistake. As lawyers know, you can choose only two among speed, quality and price. Moving too quickly often sacrifices quality.

In structuring a joint venture, it is helpful to have chosen preliminarily joint venture management. Experienced management can be critically helpful to both sides in making sure that the important business issues are attended to in the negotiation and documentation of the joint venture agreement.

Perhaps the biggest single mistake a joint venture partner can make in the negotiations regarding the IJV is to not be willing to walk away from a bad deal. As in every business transaction, there should be a point beyond which a joint venture partner will not go in respect to critical business and legal issues. “Chasing the deal” almost always results in a bad deal. One cannot negotiate a good deal unless one is willing to walk away from an unacceptable one.

Lastly, and most importantly, avoid the fatal triangle of wrong deal, wrong partner and wrong reasons. It is critical to do your homework and due diligence. Know whether and if an IJV is the right approach to a marketplace. Find the right partner. Negotiate a win-win deal and document it with a finite and comprehensive agreement that creates a business architecture that allows management the ability to make good decisions and implement them, while allowing for the flexibility needed for the organization to evolve and change as the marketplace requires.

PRELIMINARY AND DEFINITIVE AGREEMENTS

To avoid some of the pitfalls and common mistakes described above, there are certain principal matters that should be dealt with and certain preliminary steps every prospective joint venture partner should follow. First, start with a term sheet, an agreement in principle or a memorandum of understanding. Any one of these three documents serves as architecture for assuring that all of the salient business and legal issues are discussed and agreed to by the parties before a definitive agreement is drafted. They force the parties to examine the basic components of the arrangement regarding the management, income and profits, and the allocation of risk from “fifty-thousand feet” to ensure a common understanding. At the very least, such documents serve as an estoppel agreement.

In the definitive IJV agreement, the following principal matters should be dealt with comprehensively:

1. Management - It is critical that senior management be chosen early, be independent, have a clear charter and authority, and have clear reporting lines.
2. Governance - The structure of the board of directors of the joint venture entity (or the committee that will provide management oversight in the case of a contract joint venture or a non corporate entity) should be given careful thought and specified with particularity. Fairly obviously, the board should be comprised of an odd number of directors unless impasse is contemplated and dealt with elsewhere in the agreement. It is common for the two joint venture partners’ representatives to agree upon the odd numbered director.
3. Relative Contributions of Partners - The agreement should describe in as much detail as possible the respective contributions of the parties, both tangible and intangible. Depending on tax considerations, it may be appropriate to specify values for the respective contributions of the parties.

4. Allocation of Risks and Rewards - In as much detail as possible, the parties should delineate who gets what, where, when, why and how. Dividend distributions, capital calls and allocations of losses (including special tax allocations, if permissible) should be covered.
5. Alternative Dispute Resolution Provisions and Deadlock Provisions - Most joint venture partners will not choose to risk litigation in either of their respective forums. Detailed provisions and procedures for mediation and/or arbitration should be set forth. In addition, consideration should be given to impasse provisions short of mediation or arbitration as a way to resolve deadlocks that are not fatal to the joint venture.
6. Regulatory Issues - All regulatory issues affecting the joint venture should be dealt with and, those that are conditions precedent, should be set forth clearly. Those issues include, but are not limited to, export and import controls, foreign corrupt practices act (and its equivalent) compliance, companies acts (and their equivalent) and competition law (anti-trust) compliance. In a few jurisdictions, currency repatriation must be addressed.
7. Governing Law - Although the laws of the jurisdiction in which the joint venture will be principally located are commonly chosen to govern, it is not uncommon to provide for a choice of law from a neutral jurisdiction. Often, too, venue is placed in a neutral jurisdiction that is mutually convenient to both parties.
8. Ownership Transfer – In an equity IJV, provisions should set forth the restrictions on the transferability of ownership interests in the joint venture entity. The parties may agree to a variety of possible transfer arrangements, including rights of first offer, rights of first refusal, drag-long rights and tag-along rights.
9. Termination Provisions - Detailed provisions should be inserted regarding when and how the agreement and joint venture terminate. If either party is to have an opportunity to buy the interest of the other party, that mechanism should be both well thought out and set forth in detail.
10. Governing Language - Although a seemingly obvious point, IJV agreements are often written in two languages, particularly for joint ventures between American and Asian companies. One or the other of the language versions should be designated to prevail if there is an alleged inconsistency between the documents and their translations.
11. Non-Competition, Non-Disclosure, Non-Disparagement and Non-Solicitation Provisions - Whether an IJV is dissolved or ends by one party purchasing the interest of another, non-competition provisions may well be appropriate. In addition, parties commonly seek non-disparagement, confidentiality and non-solicitation of employee covenants.
12. Intellectual Property Provisions - The IJV agreement or a separate attached document should clearly delineate all rights to IP, technology, software and the like. In addition, an appropriate licensing agreement should be executed in respect to those “knowledge” items. The IJV agreement should clearly delineate ownership of intellectual property upon dissolution or termination of the joint venture.

CONCLUSION

Efficient and cost effective ways to enter foreign markets that allow companies to share risks and exploit synergies with partner companies continue to drive businesses toward international joint ventures. IJVs can provide access to unique business opportunities and new geographic markets that may not otherwise be available, especially to smaller and medium sized businesses. Companies considering embarking on an international joint venture, however, should be aware of the limitations and risks inherent in the endeavor, and they should take advantage of some of the painful lessons learned over the years. IJVs present tremendous opportunities; however, careful planning, a thoughtful structure and a willingness to remain flexible during the life of the venture are critical to increasing the chances of success.

BIBLIOGRAPHY/READING LIST

- Bamford, James D., et al. *Mastering Alliance Strategy*. 2002. Jossey-Bass.
- BenDaniel, David J., Arthur H. Rosenbloom, et al. 2002. *International M&A, Joint Ventures, and Beyond: Doing the Deal*. Wiley; 2 edition.
- Contractor, Farok J. and Peter Lorange. 1988. Why should firms co-operate? The strategy and economics basis for co-operative ventures. In F. Contractor and P. Orange, editors. *Co-operative Strategies in International Business - Joint Ventures and Technology Partnerships between Firms*. New York: Lexington Books, 3-28.
- Datta, Deepak K. 1988. International joint ventures: A framework for analysis. *Journal of General Management*. 14(2): 78-90.
- Kogut, Bruce. 1988. A study of the life cycle of joint ventures. In F. Contractor and P. Lorange editors, *Co-operative Strategies in International Business - Joint Ventures and Technology Partnerships between Firms*. New York: Lexington Books, 169-185.
- Osland, Gregory E. and S. Tamer Cavusgil. 1996. Performance issues in US-China joint Ventures. *California Management Review*. 38(2): 106-130.
- Meirovich, Gavriel. The Impact of Cultural Similarities and Differences on Performance in Strategic Partnerships: An Integrative Perspective. *Journal of Management and Organization*. Volume 16, Issue 1, March 2010.
- Parkhe, Arvind. 1996. International Joint Ventures. In B.J. Punnett and O. Shenkar, eds., *Handbook for International Management Research*. Cambridge, MA: Blackwell.
- Prescott, Darrell and Salli A. Swartz. *Joint Ventures in the International Arena, Second Edition*. ABA Section of International Law; American Bar Association. 2010.
- Steensma, Kevin H., Jeffrey Q. Barden, Charles Dhanaraj, Majorie Lyles and Laszlo Tihanyi. The Evolution and Internationalization of International Joint Ventures in a Transitioning Economy. *Journal of International Business Studies*. 2008.
- Vaidya, Sameer. International Joint Ventures: an Integrated Framework. *Competitiveness Review: An International Business Journal*. Vol. 19, No. 1, 2009.
- Valdes Llana, Ana and Estaban Garcia-Canal. 1998. Distinctive features of domestic and international joint ventures. *Management International Review*. 38(1): 49-66.
- Wilmerding, Alex. *Venture Capital Term Sheets & Valuations (Bigwig Briefs)*. 2005. Aspatore Books.
- Wolf, Ronald Charles. *Effective International Joint Venture Management*. 2000. M.E. Sharpe.