

JOINT VENTURES PART TWO OF THREE PARTS

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Part One of this three-part series addressed the structure of joint ventures, including a discussion of how various tax and business issues affect the structure. Part One also addressed various issues that the venturers should consider when deciding on the purpose and scope of the joint venture. This Part Two concerns the financial aspects of the venture; that is, how it is funded, how the benefits are allocated, and who calls the shots.

HOW WILL THE JOINT VENTURE BE FUNDED?

Initially and During the Life of the Joint Venture. There are two aspects of joint venture funding: (i) the respective obligations of the venturers at the time of the formation of the joint venture and (ii) their respective obligations to provide funding during the life of the joint venture. The ground rules should be clearly established at the beginning. The joint venture agreement should state the venturers' rights and obligations to make mandatory and optional cash contributions, as well as mandatory and optional loans to the joint venture.

Typically, the joint venture agreement will establish procedures whereby the

venturers develop and agree upon an annual budget for the joint venture. Thereafter, contributions that are required to fund the joint venture's operations pursuant to the agreed budget will usually be at the call of the joint venture's managers.

A Process for Developing Consensus. Funding the joint venture necessarily involves issues related to value, relative capital contributions, and economic interests.

A lawyer representing a particular venturer might be tempted to negotiate aggressively in an effort to minimize the resources that his client must devote to the joint venture and to maximize his client's share of the future profits of the joint venture. Such a lawyer would work to get as much of the ownership interest of the joint venture for his client—for as small a contribution of capital—as is possible. Obviously, the lawyer would recognize that larger capital contributions would benefit the joint venture and thereby be in his client's interest. Nevertheless, most lawyers would approach the issues related to the financial contributions from the perspective of his client and not as an advocate for the joint venture. Unfortunately, this approach could interfere with the establishment of a strong joint venture.

The financial needs of the joint venture will become more readily apparent if the venturers first develop a strong business plan for the joint venture. Such a plan should be developed by a team of business people from each venturer and should include strategies for maximizing the synergies among the venturers and a list of resource requirements such as cash, assets, technology, and management. Thereafter, each venturer should establish a team to analyze the joint venture from

the venturer's own perspective. This second team would consider the capital contributions that the venturer would be required to make, assess the expected return on the venturer's investment, value each of the venturer's contributions, and negotiate issues such as initial contributions and distributions upon liquidation.

If each venturer adopts this approach, then each venturer would have a team of business persons and lawyers who would act to protect its interests, but there would also be a third team that would approach the planning process from the perspective of the joint venture. The joint-venture team would consider the constraints imposed by the individual venturers, but would, at least initially, develop its plan without significant input from the negotiating teams of each venturer. Discussions about value and capital contributions are often adversarial and disruptive, especially if they take place before the benefits of the joint venture are fully understood. Such negotiations can interfere with the development of a spirit of cooperation, which is essential to getting a joint venture up and running. After the venture team has prepared the initial draft of the business plan of the joint venture, the teams representing each venturer can then begin to provide more input.

The Problem of Non-Cash Contributions. Non-cash contributions to the joint venture present special problems. Venturers often fund the joint venture by contributing services, technology, products, or other assets to the joint venture, both at the time of formation and during the operation of the joint venture. To the extent a venturer will be making any non-cash contributions, a procedure should be established at the outset of the joint venture to determine the value of such contributions.

HOW WILL BENEFITS AND LOSSES BE ALLOCATED?

The venturers have considerable flexibility in structuring the allocation and distribution of profits, losses, and other items of the joint venture. For example, if the joint venture is expected to have operating losses initially, it would be advisable to structure the joint venture in a manner that permits the allocation of a disproportionate share of such losses to the venturer that has income against which such losses can be offset, while allocating a disproportionate share of any other benefits or net income in future years to the other venturers.

If one of the venturers is going to provide a greater portion of the financing for the joint venture, then it might be appropriate to structure the joint venture as a corporation or a limited liability company that has both common and preferred equity interests, with specified liquidation, dividend, and other preferences.

In summary, the venturers should structure the joint venture in a way that makes the best use of all available financial benefits, regardless of whether they are income, gains, losses, deductions, tax credits, or other items.

HOW WILL THE JOINT VENTURE BE GOVERNED?

A Governing Board with Restricted Authority / Key Decisions. The joint venture agreement, whether it is a shareholder agreement, a partnership agreement, an operating agreement, or other document, should specify how the joint venture will be managed, both strategically and on a day-to-day basis.

Joint ventures are usually managed by some sort of board on which each of the venturers will have a representative. Often, the representation is more or less proportional to the respective ownership interests of each venturer. To avoid

deadlocks, the joint venture agreement may provide for an independent member of the board, who would be appointed by means of a specified process, in order to address the possibility of deadlock on the board.

It is very common to provide that certain key decisions of the joint venture must be made pursuant to the unanimous approval, or the approval of a supermajority, of the members of the board. These key decisions include such things as:

- establishing an annual budget;
- making capital expenditures in excess of specified amounts;
- incurring indebtedness;
- initiating or settling litigation;
- making acquisitions or divestitures;
- establishing strategic plans;
- changing the joint venture's research and development effort;
- deciding transfer pricing issues to and from the venturers;
- appointing the top officers of the joint venture;
- selecting the accountants;
- entering into contracts involving more than an agreed sum; or
- entering into contracts between the joint venture and one of the venturers or any of its affiliates.

The Goal: Authority Commensurate with Responsibility. In structuring the governance provisions, the venturers should understand that the essence of a joint venture is that neither venturer has full control. Accordingly, one of the most

difficult aspects of structuring a joint venture is to establish a smoothly functioning decision-making process, while at the same time protecting the interests of the venturers.

The McKinsey study, mentioned in Part One, concluded that many joint ventures fail, because the management of the joint venture lacked adequate decision-making authority. In a joint venture where the ownership is equally divided, assigning the management power is particularly difficult. Nevertheless, the McKinsey study concluded that such joint ventures have a substantially higher success rate and longer lifespan than those with uneven ownership.

The Fear of Letting Go. Many lawyers approach the issue of governance with the attitude that the ideal joint venture is one that their client controls. Consequently, lawyers often advise their clients to seek control of the governing board of the joint venture, because this approach will accomplish two objectives:

- (1) it will ensure a clear decision-making process (*i.e.*, we decide) and
- (2) it will protect the venturer's interests (*i.e.*, since we decide, we can easily protect our interests).

This attitude might be acceptable if there is a significant disparity between the strengths or ongoing contributions of the venturers, or if one of the venturers sees the joint venture as a possible interim step toward a divestiture and is, therefore, willing to allow the other venturer to control the joint venture. Normally, however, it is not the best approach.

If neither venturer is willing to allow the other to have majority ownership or control of the joint venture, then lawyers will often attempt to reduce the risk of

deadlocks and disputes by drafting detailed provisions that specify that both venturers will have equal seats on a managing board. Although such a joint venture agreement might provide that the managers of the joint venture will be given responsibility for the day-to-day operations of the joint venture, both venturers will have veto power over a list of key decisions, such as those listed above.

If either venturer vetoes a key decision, the joint venture agreement will usually provide for a process that requires the venturers to use their respective best efforts to resolve their differences, and failing that, to refer the issue to a higher level within their respective organizations or to a third-party mediator or arbitrator. If all of these dispute-resolution procedures fail, then the joint venture agreement might provide that the joint venture may be terminated under pre-agreed conditions.

Although this approach sounds good in principle, careful consideration of it reveals that the approach is not as good as it initially appears. The problem is that the list of the “key issues” often incorporates most, if not all, of the decisions that really matter to the joint venture. And there are almost always conflicts about several of these issues during the first few years of the joint venture’s existence. Consequently, a deadlock is a very real possibility.

A Multi-Faceted Approach to Governance of the Joint Venture. The likelihood of deadlocks can be reduced by employing four procedures that will allow for the protection of the interests of the venturers, while at the same time minimizing the risk that a conflict will lead to a termination of the joint venture.

First, the veto powers of the venturers should be permitted only when they

are absolutely necessary. In other words, they are appropriate only when other approaches to protecting the interests of the venturers are inadequate. These limited powers would usually involve decisions about changes in the scope of the joint venture or legal or fiduciary responsibilities.

Second, the joint venture should adopt principles that can be used to answer the most important questions that the joint venture is likely to face. For example, the joint venture should adopt policies for setting transfer prices, the criteria that will be used to recruit senior managers, the conditions under which major investments or acquisitions would be made, and the range of likely dividend payments that the venturers might receive. The policies could include alternative scenarios based on the profitability of the joint venture, as well as the needs of the venturers. In addition, the venturers should revise and supplement the policies from time to time.

Third, the joint venture agreement should include provisions that permit the joint venture to be restructured, short of termination, in a way that will avoid or resolve a conflict after it arises. For example, as described above, the joint venture could:

- provide that one venturer may fund investments, while the other is diluted;
- allow one of the venturers to engage in activities within the initial scope of the joint venture, if the other venturer has prohibited the joint venture from pursuing such activities; or
- allow the joint venture to buy crucial inputs or sell its output in the open market if the venturers fail to reach agreement on transfer prices.

Finally, the joint venture should consider adopting other procedures for avoiding deadlock. For example, the joint venture should have clear procedures in place concerning how significant decisions will be made. Such procedures should specify the level at which the decision will be made, whether the decision will require board approval, and whether the decision will be determined by a majority vote of the board, or by a supermajority or unanimous vote of the board. Finally, the board should include persons from each venturer who have the power to decide all of the issues that are likely to be raised.

Despite the best efforts of the venturers and their attorneys, the joint venture might run into difficulties that the parties are unable to resolve. Accordingly, please review Part Three of this series, which concerns various “back-end” issues, such as the sale of a joint venture interest, the failure of a venturer to honor its obligations to the joint venture, and how the joint venture ends.

The matters discussed in this paper involve a complex area of the law. Despite the length of the paper, it is not an all-inclusive discussion of the issues presented and does not represent legal advice. Accordingly, it should not be relied upon without consulting a qualified attorney.