

**JOINT VENTURES  
PART ONE OF THREE PARTS**

by  
William H. Venema  
[bill@thevenemareport.com](mailto:bill@thevenemareport.com)

A cursory review of most any business publication reveals that joint ventures have become extremely popular in recent years. Venturers form them for a variety of reasons. They allow venturers to combine, and take mutual advantage of, complementary experience and expertise, technologies, management talent, and financial resources. Accordingly, most managers see them as an expedient way to enter into new markets; to gain skills, technology, or products; or to share fixed costs and resources. Nevertheless, the task of forming a joint venture is not easy. Some experienced business professionals contend that joint ventures are fraught with problems and all but doomed to failure.

This paper is Part One of a three-part series that will help the reader avoid the most common pitfalls. Part One addresses how the joint venture should be structured. Part Two concerns the financial aspects of the venture; that is, how is it funded, how are the benefits allocated, and who calls the shots. Part Three discusses the “back-end” issues, such as whether one of the venturers can sell its interest, what happens if a venturer fails to honor its obligations to the joint venture, and how does the joint venture end.

For the sake of discussion, let's define a joint venture.

#### **Definition of Joint Venture**

*A joint venture is the development of a business opportunity by two or more entities acting together.*

Joint ventures may be conducted through a variety of structures and need not involve the creation of a separate legal entity. Joint ventures can be corporations, partnerships, limited liability companies, or trusts, or they can simply be contractual arrangements between or among the parties to the joint venture.

Designing an appropriate structure for a particular joint venture will depend on a variety of factors, including:

- tax and accounting goals,
- business objectives, and
- financial needs.

Certain core issues should be addressed at the time of formation. The three parts of this paper will discuss those core issues in a general fashion. It is, however, beyond the scope of this paper to explain the precise manner in which such issues should be addressed in every conceivable situation. Nevertheless, Parts One through Three should provide good "food for thought" if you are considering forming a joint venture.

#### **WHAT SHOULD THE STRUCTURE OF THE JOINT VENTURE BE?**

*A Variety of Structural Choices.* The first step in forming a joint venture is to determine what "it" is going to be. There are a variety of alternative structures to choose from. If the joint venture will be operating principally in the United States, it can take the

form of a corporation, a general partnership, a limited partnership, a limited liability company, or another form of legal entity formed under the laws of any particular state. If the joint venture will be operating principally overseas, then the venturers may choose to form an entity pursuant to the laws of the country in which the joint venture will be doing business. Finally, the venturers might decide not to form an entity at all, but rather to create the joint venture by means of contractual relationships that establish the relative rights and obligations of the venturers.

*Limited Liability and the Structure of the Joint Venture.* There are, of course, a variety of issues to consider in deciding upon a structure for the joint venture, including limited liability, governance, and tax considerations. Being rather risk-averse creatures, lawyers typically focus on limited liability. To achieve this result, they usually recommend forming a corporation, limited liability company, or limited partnership. There are, however, other ways to achieve limited liability, and so this goal should not dictate the selection of a particular form of entity.

*Governance Issues and the Structure of the Joint Venture.* Governance issues normally do not force the venturers to choose one form of entity over another. Although different types of entities use different management structures, the venturers can usually achieve their governance goals, regardless of the form the venture takes. If the entity is a corporation, then the governance issues can be addressed by:

- the manner in which the board is selected,
- various provisions in the bylaws, and
- sometimes, a shareholder agreement.

If the form is a limited liability company, then most governance issues can be addressed in the operating agreement. In a joint venture based on contractual provisions, the parties are free to fashion virtually any governance structure they might choose.

*Tax Considerations and the Structure of the Joint Venture.* Practically speaking, tax issues are at least as important as limited liability or governance issues in determining the structure of the joint venture. Although the corporate or limited liability company forms provide limited liability for venturers, venturers can also achieve limited liability even if they opt for the general partnership or contractual joint venture forms, which may be more advantageous from a tax perspective. For example, if the venturers choose the general partnership form, they can each establish a new, wholly-owned, special-purpose subsidiary that will be the partner in the joint venture general partnership. If the venturers choose the contractual form of joint venture, they can form new corporate subsidiaries that will enter into and perform the joint venture contracts. In that case, the venturers should enjoy limited liability protection, as long as they avoid circumstances that might cause a court to “pierce the corporate veil,” such as failing to adequately capitalize the special-purpose subsidiary or otherwise failing to adhere to corporate formalities.

A key tax issue that venturers should consider is whether the joint venture entity will be taxed as a corporation or as a partnership. Venturers will certainly want to avoid the double taxation problem associated with the corporate form. Venturers may also want to use an entity that is taxed as a partnership because such entities provide greater flexibility with regard to the allocation of gains or losses. For example, a partnership may provide that one venturer will receive 50% of the gains generated by the partnership and 75% of the losses. Alternatively, the partnership may provide that one venturer will receive 80% of the profits

even though it has only 50% of the ownership interests. If these special allocations have “substantial economic effect,” then the IRS will respect them for tax purposes. See 26 U.S.C. § 704(b) and Income Tax Regulations § 1.704-1(b).

With the advent of the “check-the-box” regulations, which became effective January 1, 1997, it is now much easier to ensure that an entity will be taxed as a partnership. Any business entity having two or more venturers, including limited liability companies and partnerships, can elect to be taxed as either a corporation or a partnership, without having to satisfy previously issued standards for entity classifications.

*Business Issues and the Structure of the Joint Venture.* Prospective venturers should consider several underlying business concerns when they think about the structure of their joint venture. Several questions come to mind:

- Should the joint venture be autonomous from the venturers?
- Should the venturers have significant day-to-day involvement?
- Should the joint venture be managed by a governing body that operates without the day-to-day involvement of the venturers?
- What are the chances that the joint venture might ultimately be sold to one of the venturers or to a third party, or be spun off in a public offering?
- Do the venturers plan to make additional capital investments in the joint venture?
- Will third parties be asked to invest in the joint venture?
- What are the specific objectives of the joint venture?
- What are the circumstances under which the joint venture should be terminated?
- What financial and strategic objectives should the structure of the joint venture accommodate?
- What level of control over key decisions should management have?

Some Closing Thoughts on the Structure of the Joint Venture. Before the venturers decide on an appropriate structure, they should identify the liability and tax issues facing the joint venture and then consider them in light of the business concerns that the structure must accommodate, such as autonomous management or the possibility of a sale of the entity.

### **WHO ARE THE VENTURERS?**

The next step in forming a joint venture is to determine who the venturers actually are. Sometimes, this can be a little tricky. For example, if the joint venture is structured as a general partnership, then as discussed above, a venturer might want to form a special-purpose subsidiary in order to limit the venturer's liability. In addition, a venturer might want to use a special-purpose subsidiary for other business reasons, such as facilitating a subsequent transfer of all or a portion of its joint venture interest. If a venturer uses a special-purpose subsidiary, then the other venturers should have a clear understanding of who is actually making a particular commitment to the joint venture. It might be necessary to obtain cross-guarantees from the parent companies of the special-purpose subsidiaries, in order to ensure that the commitments in the joint venture agreement are backed up by more than a mere shell entity.

### **WHAT IS THE PURPOSE AND SCOPE OF THE JOINT VENTURE?**

The Scope of the Joint Venture: Broad or Narrow. To determine the scope of a joint venture, the venturers need to ask several questions:

- Why, specifically, are the venturers coming together?
- What will be the scope of the joint venture's business?
- What products, services, or technology will the joint venture provide?

- What will be the geographic area in which the joint venture will provide such products, services, or technology?

Answering these questions can be difficult, especially if the joint venture's business will be similar to that of one of the venturers. The nature of the joint venture's business and the goals of the venturers might dictate that the scope of the joint venture's business be defined either broadly or narrowly.

To define the scope of the joint venture, the venturers must ***establish certain boundaries between the joint venture and the venturers***. These boundaries may be described in terms of geography, product categories, customer segments, technologies, and/or fixed assets. They must identify the activities in which the joint venture may and may not engage. They must decide the extent to which the joint venture may use a technology that belongs to the venturers and who has what rights to any new technology that the joint venture develops.

A conservative approach to defining the scope of the joint venture would be to define the scope narrowly and reserve for the venturers the right to expand the activities of the joint venture in the future. Such a cautious approach would be justified, for example, if one of the venturers planned to enter into an exclusive arrangement with the joint venture for an important emerging market. The venturer would be rightly concerned that if the joint venture failed to perform, the venturer would be unable to expand its market share or reap the anticipated royalty fees. Accordingly, the venturer might want to limit the geographic scope of the joint venture's business, or enter into a non-exclusive agreement, or limit the term of the agreement, or establish minimum performance requirements (which if not met would cause the joint venture to lose its exclusive contract).

Defining the joint venture's scope narrowly is not always the answer, however. A narrow scope will limit the joint venture's ability to respond to changing conditions and can lead to conflicts between the venturers and the joint venture or between the venturers, concerning how the joint venture should respond to a particular change. Defining the scope narrowly might ensure that the intellectual property of the venturers is protected, but it could also interfere with the development of the joint venture. Finally, if the joint venture's scope is narrow, then the joint venture would have to depend on the venturers for resources, such as marketing and sales support and manufacturing capacity. Consequently, transfer pricing issues (*i.e.*, the prices that the venturers charge the joint venture for such items) would be an issue between the venturers and possibly with taxing authorities as well.

One could also legitimately advocate an approach that is the complete opposite of the conservative approach of narrowly defining the scope. Defining the scope of the joint venture broadly would provide the joint venture with the flexibility that most new business enterprises need in order to succeed.

In an article entitled "The Way to Win in Cross-Border Alliances," which was published in the November 1991/December 1991 edition of the *Harvard Business Review*, the authors report on a study of joint ventures conducted by McKinsey & Company. That study confirmed that if a joint venture's scope is narrowly defined it will likely cause problems for the joint venture. The study found that most joint ventures have major conflicts during the first several years of existence. Those that were successful usually needed to be substantially expanded in scope in order to survive. Of the joint ventures examined in the study that failed to meet the strategic and financial objectives of the venturers, one of the most common causes of failure was that the scope of the joint venture was too narrow. If someone

suggests that the solution is to have a narrow scope initially and then expand it at the appropriate time, let me suggest that this is much easier said than done.

To increase the chances that the joint venture will succeed, the venturers should attempt to eliminate the possibility of conflicts between the current business of the venturers, on the one hand, and the business of the joint venture, on the other. This goal can be accomplished by giving the joint venture a sufficiently broad scope and restricting the right of the venturers to engage in activities within that scope. There should be no significant overlap between the business conducted by the joint venture and the business in which the venturers continue to be engaged.

If possible, the venturers should not be current or potential future competitors in the specific business to be conducted by the joint venture. ***Collaborating to compete does not mean collaborating with direct competitors.*** The McKinsey study found that joint ventures between direct competitors are more likely to fail and are more likely to terminate within the first three years than joint ventures involving venturers that are not direct competitors.

**Exclusivity within the Scope of the Joint Venture.** A related issue to defining the scope of the joint venture is the extent to which the venturers agree that the joint venture will, as between them, have the exclusive right to engage in a particular business activity.

Traditional wisdom says that:

- venturers should establish exclusive arrangements only when necessary; and
- to the extent they do establish an exclusive arrangement, they should link the term and scope of the exclusive arrangement to specific performance requirements, so that the exclusivity will be lost (or the joint venture may be terminated) if the joint venture fails to meet certain minimum performance requirements within a reasonable time period.

Applying the traditional wisdom is not always appropriate, however, because exclusivity provisions may need to address a variety of issues. For example, what happens if the joint venture does not have the funds to pursue particular prospects, projects, or opportunities within its scope? Also, where the joint venture has its own managers, and they are relatively autonomous, what happens if the managers decide not to pursue a particular project or market?

One approach to dealing with these issues is to make exclusivity absolute. In other words, even if the joint venture cannot or does not pursue a specific opportunity that comes within the joint venture's defined "scope," all of the venturers are prohibited from engaging in such activity. For example, if a joint venture were organized to exploit certain patents, and the patents were transferred to the joint venture entity, then only the joint venture could pursue them. If the venturers agreed to this approach in the beginning, then they would be tying their interests to those of the joint venture in a very serious way. Depending on the situation and the respective interests of the parties, tying the interests of the venturers to the joint venture might or might not be advantageous to a particular venturer.

The opposite approach would be to allow each venturer to pursue opportunities that are within the "scope" of the joint venture, but are not being pursued by the joint venture. Such an approach gives the venturers more flexibility, but demonstrates less of a commitment to the joint venture.

A middle-ground approach would be to provide that if one or more venturers, but not the required number of venturers, vote in favor of the joint venture funding and pursuing a particular opportunity, then only those venturers that voted in favor of pursuing the opportunity would be permitted to pursue it.

If the venturers or their affiliates have the **ability** to compete with the joint venture, then in order to **ensure compliance** with the terms of the agreement concerning exclusivity, it might be necessary to have the venturers agree to **refrain from competition** and to cause their affiliates to do likewise. In addition, the venturers should consider that, as partners in a joint venture, they are under a fiduciary obligation to act with loyalty toward the joint venture. This duty can cause problems if the venturers fail to address the issue in advance, because for a variety of reasons, they might be tempted to compete with the joint venture, to the detriment of the joint venture. Restrictions on the venturers, by contract or by operation of law, are intended to ensure that a venturer does not neglect or undermine the joint venture in favor of its own, competing business.

If you want to learn more about joint ventures, take a look at Parts Two and Three. Part Two addresses the financial aspects of the venture, while Part Three concerns “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 with a qualified attorney.***