Executing a Global Growth Agenda: Cross-Border Joint Ventures

Michael M. Hupp† and Anshu S. K. Pasricha‡

As part of its “Executing a Global Growth Agenda” series, Koley Jessen will publish a series of articles that will discuss in greater detail the issues raised in this article, as well as other issues that routinely emerge when negotiating mergers, acquisitions and joint-venture transactions, especially in the international markets. If you would like to be included on an email list to receive such future publications, please send an email to Jessica Kinnersley (Jessica.Kinnersley@koleyjessen.com). An abridged version of this article has been published in the October 2014 issue of Today’s General Counsel.

Joint ventures (“JVs”) are often a preferred business development strategy for U.S. businesses, especially for those that are looking for growth in emerging and other international markets. At the same time, outbound mergers and acquisitions from businesses in non-U.S. markets also commonly take the form of an equity or strategic minority investment. Businesses enter into such JVs for a variety of reasons, including: (a) access to capital, (b) access to new geographic markets, especially those that are either otherwise closed to international investors, or where local regulatory schemes make it difficult to go it alone, (c) access to technology and expertise, (d) synergies by way of sharing costs of large scale investments, and (e) managing and sharing risks in uncertain markets. This article first explores strategic considerations that management should take into account when entering into JVs, and then discusses certain issues in documenting JV agreements.

Key Considerations for Managements Evaluating JVs

Identifying specific objectives is the crucial first step for management teams considering a joint venture arrangement. Unfortunately, management teams of the joint-venturers quite often do not identify their objectives for the JV and the timeframe within which the joint-venturers expect to achieve such objectives. As a result, tensions may arise between the joint-venturers even as the JV is getting off the ground, which sows the seeds of a failure down the road. The following issues merit consideration and discussion between management teams early in the negotiations of the JV:

† Mike is the President of Omaha based law firm Koley Jessen, P.C., L.L.O. and chair of the Firm’s M&A/Securities practice group. Mike spent the first few years of his career as a litigator, but as the Firm’s needs changed, so did Mike’s role. Mike has now over 30 years of experience advising clients in high stakes corporate transactions, including mergers, acquisitions, engaging hostile business partners, and other complex “change of control” transactions in a wide variety of industries.

‡ Anshu is a Shareholder and a member of the M&A/Securities and Business/General Counsel practice groups at Koley Jessen P.C., L.L.O., where he counsels strategic corporate clients as well as private equity sponsors in domestic and international mergers and acquisitions, joint ventures, divestitures, and in general corporate matters. Prior to joining Koley Jessen, Anshu was an associate with Sullivan & Cromwell LLP in New York and Australia, and with White & Case LLP in New York.
1. **Strategy**: Joint-venturers may have different strategic interests, and therefore the relative importance of the JV to each joint-venturer may be vastly different. This affects the nature of degree of integration of the joint-venturers in the JV. Occasionally, as a result of difference in the ability and desire of the joint-venturers to commit significant resources to the JV, and the form (i.e., types of assets) in which such resources are to be committed to the JV, there develops a further gap and strategic inconsonance between the joint-venturers. Accordingly, alignment of interests is a critical element to a successful JV, and such alignment can be better achieved by appropriately valuing the assets and any services to be provided to the JV by the joint-venturers, specifying clearly the goals for the early years of the JV, and ultimately, documenting such goals in the JV agreement.

2. **Organizational Issues**: Joint-venturers must consider “soft” issues such as cultural differences among the joint-venturers, and conflicting incentives that may drive each of the parties to the JV. Unless and until certain key employees of the joint-venturers are committed to spending significant amount of time with the JV, the JV’s long-term success may be undermined. As a result, depending upon the managerial model chosen by the JV (i.e., whether one joint-venturer is “operations” partner, or if different joint-venturers contribute in different areas of operations) quite often the JV agreements will provide that certain key employees of each of the joint-venturers will spend a certain amount of time in connection with the activities of the JV, as well as that a smaller sub-set of employees will be seconded full-time to the JV for a specified duration so as to focus on building the JV from the ground-up and ensuring its success.

3. **Governance**: Typically, because joint-venturers share the decision-making at the JV level and because each joint-venturer may have different decision-making processes (e.g., difference in reporting systems, processes and metrics that are followed by the joint-venturers) governance of the JV can be complicated. In order to provide for more efficient governance and decision making, a JV should consider forgoing a linear flow of decision-making in the JV and instead devising carefully crafted roles and responsibilities for each joint-venturer.

4. **Economics**: Joint-venturers may desire to have geographic and other restrictions on the operations of the JV, and may otherwise desire to engage in certain business opportunities outside the JV when such business opportunities could also be explored by the JV. Further, depending upon the circumstances, the joint-venturers may, or may not, have the ability or the desire to guarantee the obligations of the JV. Finally, joint-venturers may wish to provide ongoing services, staffing and other resources to the JV, and may charge market rates for such items. All of these issues affect the economics of the JV. If the joint-venturers have not spent enough time socializing these issues internally and with each other, it may lead to a misalignment of interests among the joint-venturers and sow the seeds of a failure down the road.

Honest discussions in respect of these exploratory themes determine the negotiating stance of management vis-à-vis the JV and the counterparty joint-venturer. This in turn has a significant impact on documenting governance of the JV, funding of the JV, and exit and liquidity rights, each of which in turn has a lasting impact on the formation and ultimately the success of the JV.
Documenting JV Agreements

JVs can take multiple forms. Often JVs are formed for a single purpose, but occasionally, such JVs can take the form of “platforms” on which both joint-venturers seek to build long term growth model. Regardless of the form of the JV, the key issues generally remain the same. When negotiating JV Agreements, the joint-venturers need to take into account governance of the JV, funding of the JV, transfer restrictions, exit rights and liquidity provisions, and deadlock and dispute resolution mechanics.

Governance

The governance provisions in a JV agreement vary widely depending upon the management model chosen for the JV as well as the ownership structure of the JV. As an example, the governance package for a JV in which two joint-venturers are strategic parties and are equal interest holders in the JV entity often means joint decision-making for almost all, if not all, matters. As a result, the JV board or other managing body is typically staffed with equal number of appointees from each of the joint-venturers. There are variations of this approach that can be implemented, including having additional appointments of independent directors on the board. In such set-ups, typically the board will act with respect to routine decisions, or within specified parameters, by a majority or supermajority. However, more critical decisions are then relegated to a list of “Unanimous Decisions” that may be undertaken only upon approval of all the members of the board. On occasion, such Unanimous Decisions can only be taken upon approval by the members of the board, and further approval by both the joint-venturers. As a result, in 50:50 JVs, unless both joint-venturers are in agreement on an action to be taken by the JV, usually the JV cannot act, and deadlock results (more on this below).

In JVs with unequal ownership structures (e.g., a 25:75 JV), governance gets more complicated. Typically, the majority joint-venturer would want to (i) operate the business of the JV with as little interference as possible from the minority joint-venturer, and (ii) retain control over decision-making with respect to as many issues as possible. On the other hand, the minority joint-venturer will push for some control over a list of key issues and actions that it views critical to protecting its own rights (e.g., right to participate in any change of control in the JV, and anti-dilution provisions that give the minority joint-venturer the option to maintain its ownership percentage in the event that new money comes in at a higher valuation (see also Funding below)), as well as to maximize the benefits that accrue to it as a result of a successful JV (such as changing distribution mechanics). Any decision in respect of such items typically requires that either the joint-venturers agree to take such decisions only after a “supermajority” vote of the board. In the case of a JV involving only two parties, typically an affirmative vote of the minority joint-venturer is required prior to any action being taken by the JV in respect of such listed matters. As a general rule, as the stake of a minority joint-venturer increases, the list of items and issues over which the minority joint-venturer’s vote would be required also increases. In any event, these items typically get hotly negotiated, and despite proclamations to the contrary by many a prominent counsel, there is no “market” for what such terms typically include. JVs are, by their very nature, “one-off” transactions, and therefore every element gets negotiated
taking into account the overall dynamics of business and negotiation leverage that each party holds.

In any event, in all of these scenarios, there is ultimately a business risk that joint venturers may not see eye-to-eye after the JV starts to operate. As a result, a deadlock arises in that both joint-venturers are within their rights to disagree on certain matters, cannot make any decisions in respect of such matters, and worse, may not be able to operate the JV. As a way to minimizing any disruption to the operation of the JV because of a deadlock between the joint-venturers, the joint-venturers should consider negotiating a business plan for the JV that would be attached to the joint-venture agreement. Such a business plan would include, among other things, detailed metrics including operational targets and financial milestones, funding requirements, and brand strategies. The JV would adopt the business plan at the time that the JV agreement is negotiated and executed, and any changes to such a plan are then not permitted without the approval of both the joint-venturers. Such an arrangement could last for a fixed number of years, or until the joint-venturers feel the need to revisit the business plan, with a review of the business plan scheduled for pre-specified times (such as on an annual or biennial basis).

**Funding**

In all JVs, financing is a critical item. This is because unless both joint-venturers agree on the terms and form of the funding, it is unlikely that the financing needs for the JV will be satisfied. Accordingly, the JV agreements typically give careful consideration to debt and equity financing in the future for the JV. Although quite often joint-venturers’ preference is to utilize third party debt financing sources as future funding sources, JV agreements typically also include provisions that contemplate joint-venturers funding the business by putting in more equity, or bringing in new equity investors.

In JVs where there is a majority joint-venturer, typically there are provisions that require that any debt funding be either (1) on arm’s-length terms or (2) if proposed to be funded by one of the joint-venturers on other than arm’s-length terms, approved by the other joint-venturer. In addition, any future issuances of equity (or instruments convertible or exchangeable into equity) are also typically subject to pre-emptive rights so that all parties are entitled to take up a pro-rata portion of such equity issuance and avoid being diluted. This provision, however, would not work if one of the joint-venturers is financially constrained. If this issue is a concern to one of the joint-venturers, then such joint-venturer may negotiate to obtain rights in the JV agreement that provides it the right to have the other joint-venturer to divest certain portion of equity when the financially constrained joint-venturer is able to obtain financing to purchase such additional equity. Finally, minority joint-venturers typically demand that any equity securities not be issued without its consent (even when the documents provide for pre-emptive rights). This provision is typically hotly negotiated as it gives the minority joint-venturer, who may not have the ability or the desire to put in additional capital, additional leverage to get something in return or otherwise threaten the JV’s survival when its own limited capital is at risk.
Transfer Restrictions, Exits and Liquidity

JVs involve a significant amount of collaboration and a differential skill-set of each of the joint-venturers, and therefore, rarely do joint-venturers consider each other as fungible parties. As a result, certain direct and indirect transfers of joint-venturers’ ownership interests are usually prohibited in the JV agreement. If the JV agreement permits such a transfer, it typically still includes elaborate transfer restrictions that generally purport to lock the joint-venturers up for an agreed period of time—most common being 2 to 3 years, although this time period depends on the time horizon within which the JV is expected to be fully functional.

After the initial lock-in period has elapsed, joint-venturers may be able to freely transfer their ownership interests, subject to provisions such as (i) forced-sale provisions including (a) put rights (permitting a joint-venturer to sell its ownership interest to the other non-selling joint-venturer for a price calculated in the manner prescribed in the JV agreement) and (b) call rights (permitting a joint-venturer to purchase the ownership interest of the other joint venturer for a price calculated in the manner prescribed in the JV agreement), (ii) drag-along rights (permitting the selling joint-venturer to force the other joint-venturer to sell its ownership interest in a sale to a third-party on the same terms and conditions as the selling joint-venturer is proposing to sell to such third-party), (iii) tag-along rights (permitting the non-selling joint-venturer to force the third-party purchasing the selling joint-venturer’s interest to purchase the non-selling joint-venturer’s interest as well on the same terms and conditions as the third-party is proposing to purchase the selling joint-venturer’s interest), and (iv) (a) rights of first offer (requiring a selling joint-venturer to offer its ownership interest to the non-selling joint-venturer prior to offering such interest to a third-party) or (b) rights of first refusal (requiring a selling joint-venturer to grant the non-selling joint-venturer the right to first purchase the interest being offered by the selling joint-venturer to a third-party on the same terms and conditions as being offered to the third-party). There are nuances with respect to conditions under which each of such rights can be exercised by any party. However, as a general principle, taken together, these provisions are intended to ensure that a joint-venturer is not able to get out of the JV unless (1) the other joint-venturer is also able to exit the JV on the same terms, (2) the other joint-venturer is willing to buy out the exiting joint-venturer’s interest or (3) the other joint-venturer is willing to remain in the JV with a new joint-venturer who comes into the JV as a replacement for the original joint-venturer.

Finally, there are liquidity provisions that allow for one or more of the joint-venturers’ exit from the JV. These provisions typically provide that within a set period of time—most common being 5 years from the date of formation of the JV—the joint-venturers will exit the JV by way of an IPO or other change of control transaction. Typically, such provisions also provide that if the exit event has not happened by mutual agreement within such specified time period, then either joint-venturer can force an IPO or sale of the company to a third-party buyer, provided that the price received in such transaction exceeds a minimum threshold price.
Deadlocks, Disputes and Resolution Mechanics

Deadlocks and disputes are distinct issues that result in joint-venturers resorting to use of elaborate conflict resolution provisions that are typically included in the JV agreements. Deadlocks arise when joint-venturers exercise their rights in accordance with the JV agreement, but fail to reach a mutual understanding. Without agreement to the contrary, if the joint-venturers cannot agree to a mutually acceptable manner in which to resolve the deadlock, there is likely no alternative solution other than to unwind the JV. As a result, the JV agreements typically provide for elaborate escalation mechanism to resolve such deadlocks. As a result of a deadlock, joint-venturers will often raise the culprit issue out of the board room of the JV to the senior management of the joint-venturers, and then, if the culprit issue is technical, progressively to an often non-binding mediation or submission to an expert, binding or non-binding arbitration. While these escalation mechanisms may be included in the JV agreement, as a practical matter, should a culprit issue arise that cannot be resolved by the time it reaches a point where it needs to be submitted for mediation or to an expert, the joint-venturers will likely choose to go their separate ways, or decide not to pursue the issue further.

Disputes, on the other hand, are a result of more acrimony between the joint-venturers, and typically involve one joint-venturer alleging that the other joint-venturer is in breach of the terms of the JV agreement hence depriving it of the benefit of the bargain it struck at the time that the JV agreement was negotiated. As a result, the JV agreements contain multiple and significant layers of escalation mechanics. Typically, such layers include, progressively: (a) cooling off period, (b) escalation of the issue to the senior management of the joint-venturers, (c) mediation or submission to an expert, (d) arbitration, and (e) litigation. As a result of these layers, and consequently, hurdles which the parties must cross to resolve their disputes, joint-venturers typically have a huge incentive to resolve the issues early and by mutual agreement, and internally, before these issues become disputes. Once a “dispute” has arisen, the resulting acrimony likely leaves an amicable resolution all but impossible. Even after the dispute has arisen, quite often, these provisions are not utilized by themselves as joint-venturers try to resolve their differences by negotiating outside the contract. Having such carefully negotiated provisions can provide for significant leverage to a joint-venturer facing a less than forthright counterparty and are therefore considered valuable points during negotiations leading to the JV agreement.

Challenges Particular to International JVs

There are a few other issues that merit specific mention in connection with international JVs, especially in emerging markets. These issues are a sub-set of the issues discussed above, but with important nuances in the international context meriting a separate discussion.

1. Selection of Joint-Venturers: Joint-venturers that are capable of making tangible business contributions should be carefully diligenced. A joint-venturer should carefully diligence the nature of business in which the JV will be operating, the reputation of the other proposed joint-venturers, and should otherwise maintain strict compliance procedures, including
maintaining controls over the bank accounts of the JV so as to minimize the risk, reputational and otherwise, to the JV and to the joint-venturer. Such diligence includes undertaking standard corporate and organizational due diligence, as well as undertaking background checks on the principals and other controlling persons by employing the services of investigative firms that specialize in this area. Although it is always prudent for a business to know the counterparty, this background diligence is even more important in the context of JVs because of the increased focus of U.S. and other international governmental agencies on anti-bribery and other anti-corruption issues, including Foreign Corrupt Practices Act compliance.

2. **Maintaining Operational Control and Oversight Over the JV Activities:** Maintenance of operational control of the JV, and diligent oversight over the activities of the JV, is critical for JVs operating in international markets. This requires managing relationships and interactions between senior executives of the joint-venturers, and otherwise having non-linear reporting channels in place. Without such non-linear reporting channels, because of cultural differences, quite often senior executives may not become aware of issues until they turn into significantly bigger problems.

3. **Safeguarding Intellectual Property:** Safeguarding proprietary technology is a critical item for all JVs operating in emerging markets because of difference in intellectual property protection regimes that do not protect proprietary technology in the same manner as a U.S. or E.U. regime might. Typically, JVs limit access of JV personnel to such technology on a “need to know” basis. In addition, most often JV limit the intellectual property brought to the JV as ready-to-use technology and equipment rather than basic prior art so as to avoid such intellectual property being pilfered by rogue personnel.

4. **Arbitration in Neutral Venues:** Joint-venturers typically seek to avoid getting stuck in local litigation quagmires. As a result, depending upon the identity of the joint-venturers, the JV agreement will often provide for arbitration in neutral venues such as London, Singapore, Paris, etc. as the sole method of dispute resolution. Further, a good practice is to carve-out from such provisions any local laws that may otherwise seek to bring the joint-venturer within the purview of the local legal regimes.

5. **Long term ownership in the face of restrictive investment regimes:** If one of the joint-venturers considers the JV to be of strategic importance, such as to get a toe-hold in a market where it is expected that consumer growth will drive its own future growth, it may be critical for such a joint-venturer to have the ability to take control of the JV in due course. However, certain countries permit only minority ownership of domestic entities by foreign persons. In such situations it may be appropriate to negotiate for options or other “creeping acquisition” rights (i.e., ability to acquire such percentage of ownership as permitted under applicable local laws in the future at a pre-determined price) that would allow the joint-venture to, as closely as possible, achieve the business deal it sought through the JV while complying with local laws.
Conclusion

Businesses looking to advance a long-term growth agenda can possibly achieve such growth by carefully curating a set of strategic JV investments in the international markets. A JV strategy can be highly potent and with appropriate strategic maneuvering leave the long-term options for the business open. However, successful execution of such a strategy typically requires careful advance preparation, thoughtful implementation that takes into account strategic considerations, and simple but well-designed deal structures that leave room for sophisticated implementation but do not prove to be impediments in negotiating with regulators.

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