Joint Ventures

Contributing editors
Gavin Williams and James Farrell

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GETTING THE DEAL THROUGH

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Introduction

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Genesis with company law

Joint ventures, in the purest sense (namely, a collaboration between two or more legal or natural persons with the aim of conducting a shared business), have been around for as long as modern company law and are equally integral to its development. Indeed, the early laws on partnerships and companies were established to regulate the allocation of responsibility and liability as businesses moved from being sole traders to multiple parties working together.

It is often stated that the use of joint ventures is both increasing and of an increasing significance in the world of business. Viewed historically, however, whereby all partnerships and companies with multiple distinct shareholders technically classify as joint ventures, this may not be true. Often, such statements instead refer to joint ventures as vehicles established by two or more companies to pursue a common goal. There are multiple reports and studies that comment on the cyclical nature of joint ventures' prevalence, and how the number of joint ventures tends to increase in the periods immediately following economic downturns.

De-risking innovation and adventure

In the past 50 years or so, joint ventures have traditionally been used on large-scale projects in capital-intensive industries, such as energy (eg, new nuclear power stations), infrastructure (eg, high-speed rail networks), telecommunications (eg, network-sharing arrangements) and in extractive industries, such as in oil and gas production-sharing arrangements.

Often, the legal technology developed by joint ventures has been deployed by private equity firms and finance institutions to structure their financial investments. The architecture of a joint venture provides the flexibility for private equity firms and financial institutions to fund acquisitions, and the ongoing operations of the target, in a way that maximises the opportunity for growth while also helping de-risk the return on their investment.

An alternative to 'traditional' M&A

As mentioned above, joint ventures tend to become more common in periods of economic instability, and this is certainly true of the uncertain economic climate of the last 10 years. Increasingly, industries have been looking into joint ventures as an alternative to 'traditional' M&A as they offer participants the ability to spread the risk of losses in investments where returns may be uncertain, particularly when investing in new technologies, new markets or new territories. Joint ventures also allow the parties to pool resources and expertise with the aim of creating value that would otherwise be beyond any of the parties individually, and can be used as a 'first look' prior to an acquisition, allowing a potential acquirer to assess whether a full acquisition would be beneficial.

Competition risks

There are, however, many risks in establishing joint ventures. One of the key risks is that they may involve competitors or companies in complementary industries working together and sharing confidential information, which can lead to competition concerns and concerns about the loss of confidential information and business secrets (including technology). This is particularly the case in joint ventures involving a 'dominant' party: the dominant party may have more control over management and resources while the minority party provides technical expertise or specialist knowledge. The minority party will want to ensure that the dominant party does not simply replicate its knowledge with the intention of terminating the joint venture and competing with the minority party.

Security and political sensitivities

The use of joint ventures to acquire a level of control (whether actual or practical) of an asset, without effecting a full acquisition, is an increasing source of concern for governments and regulators. The political anxiety arising from foreign investors acquiring stakes in critical national infrastructure has led to increasingly protectionist agendas of many governments around the world, including the United States, Australia, the United Kingdom, France and Germany. This has resulted in many governments introducing or proposing to introduce powers of oversight and intervention over foreign investments, which would extend to joint ventures.

Structuring considerations

When establishing a joint venture, the structure of the joint venture parties will usually be driven, primarily, by the preferred tax and accounting structure for the joint venture, which includes whether the parties wish the joint venture to be tax transparent and whether they wish to consolidate the joint venture in their accounts. The structure will also be influenced by the investor protections that are to be put in place, in particular, whether the investors are seeking structural protections and priority or whether they will rely on contractual protections alone. It is also very important to consider in the early structuring stages any competition or antitrust issues that may be relevant. If the joint venture is to be established between competitors or parties in sectors that could vertically integrate, the competition authorities will want to ensure that the joint venture is not used for any improper information sharing.

Operations in practice

As well as structuring considerations, the parties should agree, prior to establishing the joint venture, how it will operate in practice and, if applicable, make suitable provisions in the joint venture agreements and constitutional documents. In particular, the parties should consider how the joint venture will operate daily (ie, will the joint venture and its management operate self-sufficiently and independent of the shareholders? Or will one or more of the joint venture parties expect to have a significant role in its oversight, management and operation?). A significant contributing factor to the success (or otherwise) of the joint venture will be whether the parties have thought about and planned for the operation of the joint venture prior to commencing their collaboration, rather than learning on the job.

For example, how will the joint venture parties manage any deadlock? A deadlock may arise if there are any matters on which all or a requisite majority of the joint venture parties cannot agree. The value of a joint venture can quickly be diminished without a mechanism to efficiently resolve deadlock to the parties' satisfaction; if the deadlock cannot be quickly resolved, the joint venture may become unable to operate, and therefore will not generate income and returns for the joint venture parties. Alternatively, if a deadlock is resolved quickly but one or more of the parties is unhappy with the resolution, unhappiness could develop into resentment. The unhappy party may desire to exit the joint venture or, at the least, may not dedicate the resources necessary to the joint venture's success.

A relationship first
Ultimately, joint ventures can only function for as long as the joint venture parties continue to cooperate. If the relationship between the joint venture parties (or a joint venture party and the joint venture itself) breaks down, it may be best for all involved that the joint venture be unwound as quickly as possible to avoid it taking a disproportionate share of the parties' time and resources.

Prior to establishing a joint venture, it will often be difficult for parties to know whether a joint venture is the best way to proceed with a particular endeavour. The chances of a establishing a successful joint venture can improve with the following strategies:

- Joint venture parties should be of a complementary cultural fit. This does not necessarily mean that both parties should share the same culture, but they should dedicate time and effort to understand and make provision for cultural differences.
- Joint venture parties should benefit from the joint venture. It is not necessary that all parties benefit equally, but it is important that they strike a fair balance so that no party feels it is getting short-changed in the relationship. Further, it is not necessary that parties are treated equally in the joint venture. In certain circumstances, having a dominant party may be an advantage (for example, if one party has a particular skill and another has the funds and resources). It is important in these situations that any expertise contributed by a minority party is not easily transferable; if it is, the dominant party may only choose to be part of the joint venture for as long as it needs to acquire the necessary experience.
- At least one party should have experience in operating a joint venture. Studies show that the greatest indicator of a successful joint venture is prior experience.

Considerable effort required
Overall, it is important that the joint venture parties, prior to commencing the joint venture, put considerable effort into discussing and agreeing upon the operations of the joint venture and how potential issues will be resolved. Discontent can spread quickly and fundamentally damage the joint venture if its first months are spent working on operational issues that could have been anticipated, and this situation can be exacerbated by the pressure that management may be under to deliver returns early in the life of the joint venture.

Given that joint ventures, as a necessity, involve parties cooperating over a prolonged period of time, parties should avoid overly contentious negotiations when establishing the joint venture. Dissatisfaction with the negotiation process, with one or more of the joint venture parties not being happy with elements of the joint venture, can increase over time.

Possibility for enhanced success
It is commonly acknowledged that a great many joint ventures fail, and tend to fail in the first three years of being established. The risk of failure of a joint venture can be mitigated by dedicating sufficient planning and resources to establishment of a joint venture, in particular, creating a governance structure that allows a trusting operating environment. Such prior planning will go a long way to ensuring that a joint venture will continue for many years. Where joint venture parties interests can be aligned, expectations understood and care taken to create an equitable balance between the joint venture parties, then pursuing a business activity through a joint venture has the potential to yield rewards greater than the sum of its parts.

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