

Reducing the Risks in Joint Ventures

A joint venture can be a **risky** endeavor.
However, a properly **structured**
agreement can help mitigate
the risks to support a
successful
partnership.

A joint venture generally refers to an arrangement between two or more organizations to form a new business (either incorporated or unincorporated) for a specific purpose. The reasons that joint ventures are formed often relate to the development of new technology, the pursuit of a new market opportunity, and for sharing resources. Presumably, each of the joint venturers has determined that it is better to partner with one or more other organizations rather than to pursue the new venture on its own. The benefits gained by the parties entering into a joint venture may include a reduction in initial capital requirements, immediate access to new markets or technology, and/or access to resources that otherwise may not have been readily available.

While the benefits associated with joint ventures frequently are emphasized, the risks often are not fully considered or understood by the parties involved prior to the arrangement. By their nature, joint ventures are usually risky because of the possibility that the new product, new market or new technology for which the joint venture was formed is not viable. In addition to 'operating risks,' joint ventures sometimes fail or are considered 'unsuccessful' from the standpoint of one or more participants. This primarily is due to issues that arise in the course of interactions between the joint venture and the parties or between the parties themselves.

Contributions by the parties

When a joint venture is formed, the founding parties typically make an initial contribution to provide start-up capital. Additional contributions may also be required at other times. Where the parties contribute cash or cash equivalents, the relative contribution by each party can easily be measured. Where contributions are made in lieu of cash, the parties may disagree on the 'value' of the contribution. And in some cases, these contributions can trigger undesired tax consequences to the contributor.

When a party to a joint venture contributes tangible assets such as machinery and equipment, its value may or may not be readily apparent, depending on the nature of the assets and the valuation assumptions that are made. For example, a particular piece of equipment may have a different 'value' depending on whether it is assessed based on liquidation value, replace-

ment cost, or 'value in use' (generally determined pursuant to discounting the net cash flows arising from the use of the equipment in the joint venture). To avoid conflicts arising from differences in interpretation, the parties should agree on the basis of valuation at the outset. When the tangible assets contributed are significant, it may be desirable for the parties to jointly engage an independent appraiser to assess the value of the contribution.

More difficult valuation issues usually arise when one party contributes intangible assets to a joint venture, such as a patent or technology. In most cases, it is very difficult to value the intangible asset in isolation from the joint venture itself. If there is only one distinct intangible asset contributed,

its value might be determined by estimating the total value of the joint venture and deducting the value of cash and other tangible assets contributed. However, the valuation of the joint venture itself usually is a subjective exercise, particularly when it is formed to exploit an unproven opportunity or to develop new technology (which often is the case). To avoid problems down the road, parties should agree on the 'value' of the intangible assets to be contributed at the outset of the joint venture and should stipulate that agreement in writing.

Additional funding requirements

As a joint venture progresses through its life cycle, there may be times when additional funding is required.

Depending on the circumstances, it may not be possible or practical to raise external debt financing.

Accordingly, the joint venture contract

should set out how funding requirements will be satisfied — including whether, and to what extent, funds should be made available by the parties to the joint venture, and on what terms. In addition, the contract should set out what the consequences will be in circumstances in which additional funding is required, and one party does not contribute its relative portion (either because it is unable or unwilling to do so at the time).

The consequences of failing to meet a 'cash call' may include dilution in the equity interest of one or more of the parties to a joint venture. Alternatively, to avoid dilution, a party to a joint venture may agree to make its contribution at the cost of foregoing necessary expenditures in its principal business. Therefore, parties entering into a joint venture

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should understand their obligations regarding additional financing and be satisfied as to their likely ability to meet those needs.

Management and control

While the ownership of many joint ventures is divided equally among the participants, this is not always the case. Some joint ventures have one party with a controlling interest (i.e. more than 50% of the voting shares in an incorporated joint venture), while other joint ventures are comprised entirely of minority interests.

An important distinction should be made between representation at the board level (board of directors for an incorporated joint venture or board of management for an unincorporated joint venture), and day-to-day management of the joint venture from an operational standpoint. While the board of a joint venture may have equal representation from both (or all) parties to it, one party may be entitled to appoint management and/or be in charge of the administrative elements of the joint venture. Presumably, the party that appoints operational management will be more informed as to the risks and prospects of the joint venture. Consequently, in any subsequent negotiations between the joint venturers (such as for the acquisition of another party's interest), the party that is more involved normally will be in a better negotiating position.

In deciding on what constitutes a satisfactory level of influence over the operations of the joint venture, a party must also consider how significant the joint venture is to its principal operations, both current and prospective. This often will determine whether a party wants to be an active or passive participant. In any case, parties to a joint venture should ensure that their ability to make decisions in their principal businesses are not restricted because they are found to owe the other joint venturers a 'fiduciary responsibility' beyond what initially was contemplated. Therefore, the joint venture agreement should clearly set out the purpose and scope of its activities and any restrictions on the parties.

To protect the joint venture parties, particularly those that do not have a controlling interest, the contract should specify how decisions regarding the joint venture are to be made. This normally includes specifying:

- which decisions require approval by the board (for example, capital expenditures in excess of a certain dollar amount, financing decisions, etc.);
- whether decisions (or which decisions) are to be made by simple majority as opposed to a specified majority or unanimous approval. There may be some cases in which one party is given a veto over certain decisions; and
- how any deadlocks are to be decided, including whether one party has a 'casting vote.'

In some cases, it may be advisable for the parties to mutually agree to the appointment of one or more independent representatives to the board. This may serve to enhance both the fact and appearance of good corporate governance.

In conjunction with control and decision-making, the joint venture agreement should provide for a practical and efficient dispute resolution mechanism. This frequently involves binding or non-binding third party mediation or arbitration, whereby the disputing parties agree on an independent mediator or arbitrator. Alternatively, binding arbitration sometimes is structured such that each party appoints one arbitrator, and the arbitrators then jointly appoint a third independent arbitrator. No contract can be so complete as to anticipate all of the issues that may arise over time. Consequently, a dispute resolution mechanism that is perceived as fair by all parties can help in reducing the risks of an unfavourable outcome, or becoming involved in costly and time-consuming litigation.

Transactions with the parties involved

In many cases, the joint venture transacts with one or more of its owners for the purchase or sale of goods and services. Where the price paid or received for goods and services is higher or lower than market equivalent rates, the premium or discount effectively constitutes a subsidy between the joint venturers. However, in many cases, an arms length benchmark price is not readily available, so the premium or discount cannot be easily quantified. Given that a joint venture normally will evolve over time, often it's helpful for the parties to not only agree on prices for transactions involving related parties, but to also set out in the contract the methodology by which prices will be established. This includes agreeing on how frequently prices will be reset and

which party will absorb any variances from standard costs.

Similar issues can arise when one of the joint venturers enters into a licensing arrangement with the joint venture for the use of its proprietary brands or technology, for example. The terms of the license agreement become an integral part of the joint venture. All parties involved must carefully consider the issues surrounding the use (and restrictions on use) of the brand names, technology, and so on, the basis of establishing royalty payments, and the renewal provisions of the licensing arrangement. *(Editor's note: The Business Strategies column of the February 2001 issue of CMA Management magazine will cover this issue in more depth.)*

Finally, the agreement should set out the entitlements of ownership and use of any proprietary developments that arise from the joint venture. This is particularly important when the joint venture is formed to develop new technology. Even where developments are not anticipated, the parties or the joint venture itself sometimes stumble upon them in the course of conducting the affairs of the arrangement.

Termination and exit strategy

By their nature, many joint ventures have a finite life. The intended duration of the joint venture, and any renewal provisions, should be clearly set out in the agreement. If there is no specified termination or renewal date, the joint venturers should consider how their relationship can be terminated (if desired) at the outset, and to provide for that eventuality in the agreement. In some cases, it may be appropriate to include buy-sell provisions in the contract with specific triggering events and basis by which the price of a particular joint venture interest is to be determined. For example, it normally is prudent to stipulate that one party to a joint venture has the right to acquire the interest held by another party if that other party becomes insolvent. This may serve to protect the assets in the joint venture and to minimize disruptions. In other cases, a contract might state that the joint venture can be terminated by either party upon written notice to the other, subse-

quent to which time the operations are wound up, and the net assets are distributed to the owners.

Joint venture agreements normally contain restrictions on the transfer of the equity interests. However, an issue that sometimes arises is one in which a third party purchaser acquires one of the parties holding an interest in a joint venture, leaving the remaining parties with a new 'partner.' This may fundamentally change the dynamics of the joint venture, particularly if the other parties to the joint venture perceive the third party acquirer as a competitor. To prevent such an occurrence, the agreement should provide the parties with the right to terminate the joint venture upon a change in control of one of the joint venturers, or to buy the interest held by a joint venturer that is acquired by a third party. In the latter case, the contract may establish the basis for determining 'value,' which may represent a discount from fair market value to effectively impose a 'penalty' on the joint venturer that is acquired.

In conjunction with the termination of a joint venture, there are usually other issues that should be addressed, including non-competition provisions and the treatment of confidential information pertaining to the joint venture or the parties involved. These matters should be clearly dealt with in the agreement.

A joint venture agreement can help in reducing the risk that the joint venture will be unsuccessful because of issues that arise between the joint venture and the parties, or between the joint venturers themselves. At the outset of a joint venture, the parties involved should try to anticipate the issues that may arise during the course of the business arrangement and document their mutual understanding as to how such matters would be dealt with. For those issues that were not anticipated beforehand, a clearly established dispute resolution mechanism can help in avoiding lengthy and costly litigation. As the joint venture evolves, the joint venture agreement should also be modified as circumstances and needs change.

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