Joint ventures and alliances

A guide to the legal issues

November 2001
This guide has been prepared by Freshfields Bruckhaus Deringer. We have an active practice in joint ventures and alliances, particularly cross-border transactions which we are well-placed to service through our network of offices in Europe and other offices worldwide. A list of our offices appears at the end of this guide.

A more detailed examination of the law and practice in this area is contained in *Joint Ventures* edited by Ian Hewitt (supported by a specialist team within Freshfields Bruckhaus Deringer) and published by Sweet & Maxwell, 2001.

The information and opinions which this guide contains are not intended to be a comprehensive study and should not be relied on or treated as a substitute for specific advice concerning individual situations.

This guide is written on the basis of law and international practice as at November 2001.
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1 Why a joint venture?

Joint ventures are vital to international business. Rarely a day passes without an announcement of a significant new joint venture, alliance or collaboration. Joint venture techniques and issues arise across a wide range of transactions including:

- a collaboration on a joint research project;
- a consortium to finance and carry out an infrastructure project;
- a multiparty start-up venture to develop and exploit the benefits of new technologies;
- a joint venture with a local partner to carry on business in an ‘emerging market’; and
- a full-scale international merger of existing businesses into a jointly-owned corporate group.

Joint ventures are not an easy option. Potential problems may include differences in culture, slower decision-making processes, different commercial objectives, disagreements to resolve and the need to devote extra management time to continuing consultation and development of the venture. Studies indicate that many joint ventures end after a relatively early period; potential ‘exit’ routes must be kept in mind.

Joint ventures call for a combination of legal and commercial expertise in many areas, including corporate, regulatory, tax, pensions, employment and intellectual property law. This guide is a brief introduction to some of these fields, with a particular emphasis on issues arising in cross-border joint ventures.
2 Joint venture structures

How should a particular joint venture be structured? This will be influenced by a variety of commercial, legal, tax, regulatory and accounting considerations which need to be reviewed and balanced for the particular joint venture. Possible legal structures for joint ventures, at least in most EU jurisdictions, include:

- contractual joint venture;
- partnership;
- European Economic Interest Grouping (EEIG);
- strategic alliance/equity investment;
- corporate joint venture;
- ‘dual-headed’ structure; and
- maybe at some stage, a European Company.

Contractual joint venture

An unincorporated venture, based solely on a contract of co-operation, will often suffice. It does not involve the creation of an independent legal entity. Such an arrangement usually involves the sharing of resources (and frequently income) on terms which do not give rise to a partnership – although any sharing of net profit or loss will give rise to a partnership in law in many jurisdictions.

A contractual venture may be suitable where parties are co-operating on a limited one-off project or where cost or output (rather than net revenue) is being shared. Such a venture is often used where the parties are undertaking a specific works project, bidding for a particular contract or conducting joint R&D in a particular product area. It is a common medium for carrying out an oil or gas exploration or development project.

Contractual joint ventures also form the basis of a growing number of alliances which are being formed (often between companies in different industry sectors) involving cross-supply, licensing or sharing of benefits, facilities or expertise without the creation of an identifiable common business.

The advantages of a contractual joint venture can include:

- lack of formality or expense in forming, administering and ending the venture; and
greater tax efficiency in many cases with expenditure being incurred directly by the joint venture participants (and capable of being set off against their other profits) rather than through a separate corporate entity; this may be particularly valuable if losses are expected in the early years of the venture.

However, a contractual joint venture may also:

- lack substance or ‘identity’ (compared with a corporate entity) for marketing purposes or in dealings with third parties;
- lack a firm structure for employing senior management attached to the venture; and
- cause potential problems, including unwanted tax consequences, if the arrangements constitute a partnership.

Such a venture, depending solely on contract without the background of pre-existing corporate procedures and laws, also requires carefully drafted and detailed documentation.

**Partnership**

Partnership is a form of unincorporated joint venture. In most European jurisdictions, a partnership is created when venturers carry on a continuing business and directly share in its profits and losses. In many countries, a partnership is not a legal entity separate from its individual partners.

Some continental European jurisdictions distinguish between civil partnerships (often applicable to land-based businesses such as farming or building development) and commercial partnerships where the business involves recognised commercial activities. General commercial partnerships exist throughout Europe. Their individual legal features will, of course, depend upon the relevant national law. Some EU examples include:

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<thead>
<tr>
<th>Country</th>
<th>Legal Form</th>
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<tbody>
<tr>
<td>Belgium</td>
<td><strong>société en nom collectif</strong> (SNC/VOF)</td>
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<tr>
<td>France</td>
<td><strong>société en nom collectif</strong> (SNC)</td>
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<tr>
<td>Germany</td>
<td><strong>offene Handelsgesellschaft</strong> (OHG)</td>
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<tr>
<td>Italy</td>
<td><strong>società in nome collettivo</strong> (SNC)</td>
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<tr>
<td>The Netherlands</td>
<td><strong>vennootschap onder firma</strong> (VOF)</td>
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<tr>
<td>Spain</td>
<td><strong>sociedad colectiva</strong> (SC)</td>
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<tr>
<td>UK</td>
<td><strong>general partnership</strong></td>
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A partnership may have several advantages, including:

- flexibility and simplicity of formation and operation (rules can be written down and varied easily);
- no need to incur publicity or expense in making filings with any regulatory body (such as the Companies Registry in the UK — although if all the parties are limited companies, a UK partnership may have to produce annual audited accounts in the same way as a company); and
- tax transparency which may be advantageous in obtaining effective tax relief for capital expenditure or losses.

The disadvantages of a partnership may include:

- the absence of a corporate vehicle which can give ‘identity’ by separately owning the assets and liabilities of the joint business and provide the core for a central management structure;
- fewer ways of obtaining external finance (for instance, a partnership cannot create a floating charge as security under English law); and
- joint and unlimited liability of partners for liabilities incurred by the partnership or by any of the co-partners acting within the express or implied authority of the partnership; these difficulties can often be mitigated by establishing a partnership between specially formed subsidiary companies of the participants.

These various disadvantages, taken with other practical considerations, mean that — in the absence of strong tax considerations or professional requirements — it is comparatively rare to find a commercial joint venture business being organised on a partnership basis.

**Limited partnership**

In some jurisdictions (particularly in the US and Germany), tax and other advantages can accrue from adopting the variant of a *limited partnership*, with limited or sleeping partners who retain limited liability and at least one general partner who is responsible for the management and conduct of the partnership’s business. However, a limited partner often loses the protection of limited liability if he is engaged or involved in any way in the management of the business.

Limited partnership structures exist in most European civil law countries and, indeed, generally have more widespread use than in the UK. For instance, the GmbH & Co KG in Germany is a partnership model which combines a limited partnership (the KG) with a private company (the GmbH which acts as the general partner); this model provides the management and organisational advantages of a corporate joint venture with the benefit of tax transparency. Examples of limited partnerships in the EU include:
Mention should also be made, in relation to the UK, of the new form of limited liability partnership (LLP). While this is legally a corporate entity, and offers the benefit of limited liability to all partners, it has a flexible structure and is treated as ‘tax transparent’ for tax purposes. Although designed initially for professional partnerships, it can be used for any form of business and may become a potential vehicle for joint ventures.

**European Economic Interest Grouping**

In an attempt to encourage cross-border alliances, the European Commission fostered the European Economic Interest Grouping (EEIG), which can now be established in most EU countries. Although they are fairly informal, EEIGs have an independent legal personality which is recognised throughout the EU. Other advantages include:

- limited registration requirements and little expense in formation and administration; and
- flexibility in management and operating rules which can be tailored to a particular collaboration.

However, EEIGs have substantial limitations:

- an EEIG must have members based in at least two countries within the EU or the wider European Economic Area (EEA);
- only companies within the EEA can be members of an EEIG;
- the purpose of an EEIG must not be to make profits;
- the activity of an EEIG must be ancillary to the economic activities of its members (ie it must not operate in a different field or itself carry on an independent business);

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1 Note, however, the limitation that a company cannot be a partner in a limited or general partnership in Italy.
• an EEIG cannot have more than 500 employees;
• no single member of an EEIG can hold a majority vote;
• existing members must approve new members unanimously;
• the members of an EEIG have unlimited joint and several liability for its debts and liabilities; and
• a member of an EEIG is liable for debts incurred during its membership for a period of five years after its membership ends.

The EEIG format is of little use where the primary purpose of the joint venture is to carry on a profit-making business. It has, though, proved a suitable medium for certain cross-border professional alliances. It may also be a suitable ‘Euro’ medium for cross-border R&D collaborations between European companies or other non-profit making ventures.

**Strategic alliance/equity investment**

A looser form of collaboration is a strategic alliance falling short of any identifiable jointly-owned vehicle. Some alliances may simply establish a ‘friendly’ link between the parties as a framework for future co-operation on a project-by-project basis. Others may establish more concrete business links in terms of joint research, cross-supply arrangements, exchange of staff and/or pooling of resources. All depends on contract.

One example is a strategic equity investment – often where each party takes a small equity shareholding in the other at parent company level. In itself this is not a joint venture structure for a specific project or business, but it can provide an overall relationship against which specific business ventures between the parties can subsequently be developed and supported. Such links and alliances have become a feature, particularly, in the telecommunications field and other industries where participants are anxious to develop pan-European or global networks.

Apart from commercial and minority protection issues relating to the investment, corporate legal issues can arise from such alliances involving equity investment.

• Should there be a commitment to representation by each party on the other’s board – or at least an understanding that this will be achieved?

• What contractual restraints are to apply on subsequent disposals or acquisitions of shares? For instance, a ‘standstill’ agreement will often be appropriate.

• Notification requirements and rules on share purchasing can apply (eg in the UK, under the Rules Governing Substantial Acquisitions of Shares).
Compulsory bid rules can be triggered (eg in the UK, the City Code on Takeovers and Mergers requires a party to bid for all the shares in a public company once its shareholding reaches 30 per cent).

Corporate and regulatory requirements can apply to subsequent transactions between a quoted company and a substantial or connected shareholder. Such requirements may call for special disclosure and, sometimes, shareholder approval.

The tax position affecting dividends can also create difficulties, particularly where cross-border payments are involved.

**Corporate joint venture**

A jointly-owned corporate vehicle, holding the merged or jointly-owned business interests, is generally viewed as the most appropriate legal form for the majority of cases where a continuing business is to be run by the joint venture. Corporate entities can exist in virtually all jurisdictions – although the type of company used will depend on the particular jurisdiction. These EU examples broadly correspond to a private limited company:

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<thead>
<tr>
<th>Country</th>
<th>Corporate Entity</th>
<th>Description</th>
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<tbody>
<tr>
<td>Belgium</td>
<td>société privée à responsabilité limitée (SPRL/BVBA)</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>société à responsabilité limitée (SARL)</td>
<td></td>
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<td></td>
<td>société par actions simplifiée (SAS)</td>
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<tr>
<td>Germany</td>
<td>Gesellschaft mit beschränkter Haftung (GmbH)</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>società a responsabilità limitata (Srl)</td>
<td></td>
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<tr>
<td>The Netherlands</td>
<td>besloten vennootschap met beperkte aansprakelijkheid (BV)</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>socieddad de responsabilidad limitada (SL)</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>private limited company (LTD)</td>
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</tbody>
</table>

However, in certain countries the public company equivalent is more commonly used – for instance, in Spain the sociedad anónima (stock company), in Belgium the société anonyme (SA/NV) and in France the société anonyme (SA) may each be more frequently used for a large business undertaking than the private company.

In most US states a stock corporation is a common and flexible form of business entity. Many foreign companies, for instance, choose to incorporate in Delaware because of its well-established corporate laws – and the fact that Delaware corporations are not required to have a principal place of business in Delaware. An even more flexible (and more recently available) entity is a limited liability company (LLC) which can...
now be established in all US states. Management arrangements for such companies are extremely flexible (reflected in the terms of a written limited liability company agreement) and an LLC frequently provides a convenient joint venture structure. A particular advantage is that an LLC may elect (by ‘checking the box’) to be taxed in the US either as a corporation or as a tax transparent partnership.

The advantages of a corporate structure are essentially the converse of those for a partnership or unincorporated venture:

- a company has a stronger identity for dealings with third parties and for creating an internal management and employee structure;
- participants can have the benefit of limited liability (although in some situations there may be advantages in having an unlimited company);
- a company owns and holds assets in its own name and, generally, offers more effective mechanisms for raising finance or providing security – including security over future assets or income which may enable ‘project finance’ to be raised on a limited or non-recourse basis;
- the share structure of a company can often provide flexibility – which may assist in designing special rights for ‘founders’ or the injection of initial finance; for instance, preference shares may be issued, allowing investors to obtain a priority return on the nominal value of their shares without having any control over the management of the company; alternatively, shareholders may have the right to convert their preference shares into equity shares if certain situations occur;
- a company provides a clear structure for internal accounting and reporting; and
- in all EU jurisdictions, a company is a universally-recognised entity with an established body of corporate laws and judicial precedents.

A disadvantage is that a company will have administrative requirements under the relevant corporate laws in its jurisdiction of incorporation. Generally, audited accounts and returns will need to be filed publicly. This can result in increased costs and some loss of confidentiality. An unlimited company may sometimes be considered with, usually, less stringent disclosure obligations.

Where an international joint venture is being established to bring together different existing businesses, the most difficult question will often be: where should the jointly-owned company be located? It may also be desirable to have one or more operating subsidiaries formed in different jurisdictions. Alternatively, it may be desirable (usually for tax reasons) to have a series of joint venture companies or other jointly-owned vehicles in different jurisdictions depending on a country-by-country analysis.
‘Dual-headed’ structure
In some cases, companies wish to conduct their businesses through a single merged venture for management purposes but – for tax reasons or for the sake of maintaining national identities – also wish to maintain as legal entities their existing companies or structures. The costs of cross-border dividend payments, or of transferring and merging the legal business interests, can also lead to a need for imaginative structuring. Arrangements can be devised whereby the companies remain legally separate but are connected by contractual relationships (such as profit sharing or dividend equalisation arrangements) so that they can be operated as a single economic or business unit.

Features of such an arrangement (which must, of course, be tailored to the particular circumstances) might include a framework or equalisation agreement providing for:

- identical boards of directors of the merged businesses (or at least a joint management committee) in order to ensure a common management;
- a common method of determining the profits or losses of the merged businesses;
- profit sharing or equalisation payments if one business incurs a loss or disproportionately low profit compared with the other;
- distribution of dividends from the merged businesses to the parents or shareholders in equal or pre-agreed proportions; and
- payment of capital or liquidation proceeds from the merged businesses in the same pre-agreed proportions.

Such ‘dual-headed’ structures have so far been used primarily to merge the entire businesses of companies situated in different jurisdictions. This has often been a merger at parent company level (as in Reed Elsevier or the merger of RTZ of the UK and CRA of Australia) with each parent retaining its own corporate and national identity and own shareholders. These have given rise to a range of public company or stock exchange issues such as corporate governance, shareholder information or approval requirements and takeover implications. However, we may see a growth in the application of similar techniques to cross-border collaborations at subsidiary operating levels.

European Company
A European Company Statute, promoted by the European Commission, has now been adopted. The aim is to create a new type of company independent of national law (a Societas Europaea or SE). Each member state will need to introduce measures for its implementation. Under the regulation:
• an SE may be established, amongst other routes, by companies from at least two member states forming a joint venture company;

• an SE will be registered in the member state in which it has its head office; its share capital will be in euros;

• each SE can decide whether it should have a single or a two-tier board structure;

• an SE will be similar to a public limited company in the relevant member state in which it is registered; indeed, rules applying to public companies in the relevant member state will continue to apply in such important areas as: tax treatment; auditing and accounting requirements; directors’ duties and liabilities; offers of securities; raising, reducing and maintaining capital; and insolvency;

• employee participation will be an important feature – but there is to be no single model for employee involvement; negotiations will be required between management and a ‘special negotiating body’ of employee representatives regarding employee participation including, if applicable, representation on the SE’s administrative or supervisory body (fall-back rules will apply if negotiations fail, including the continuation of previous participation rights enjoyed by relevant employees).

The European flavour of an SE may mean that, when the proposals are implemented, it could offer some advantages as a vehicle for the establishment of a cross-border joint venture. However, the proposed combination of laws is an uneasy mixture with potential for considerable uncertainty. In addition, without genuine EU-wide corporate tax harmonisation, tax factors are still going to be crucial in establishing and locating an international joint venture. There remains a long way to go before an SE is a real practicality.
3 International joint ventures

A considerable number of joint ventures are international in nature. Economic trading barriers are being eliminated; many industries are becoming global; new emerging economies seek ‘western’ capital and technology; and, in many countries, the most practical means of market entry is through a collaboration with a local partner.

An international joint venture is not in essence different from a domestic one. The types of issues discussed elsewhere in this guide will continue to apply – particularly where the venture involves the combination of businesses in different jurisdictions. The internationalisation of business is leading in many respects to a convergence of practice, approach and solutions in structuring and documenting these types of transactions. There remain, though, a significant number of national differences. A joint venture vehicle must be founded in the jurisdiction of one country and national laws (and practice) will continue to be important.

Differences in approach: common law/civil law systems

There is considerable similarity between the structures and approach under UK and continental European civil law systems for joint ventures. Important differences nevertheless remain – sometimes of emphasis and style rather than substance. At the risk of generalisation, some differences include the following:

- there is still a broad, philosophical difference in approach to contractual drafting between common law and civil law systems; common law-derived contracts are usually longer and more detailed, creating their own self-contained contract world, while civil law contracts tend to be shorter with more reliance on implied terms or other provisions of the relevant civil code to supplement the express rights and obligations of the parties;

- there are important differences in liability for pre-contractual behaviour; many civil law jurisdictions have broader doctrines than English law – including liability in certain circumstances for failure to negotiate in good faith or improperly breaking off negotiations without good reason;

- similar notions of good faith in contractual dealings under civil law systems can impose wider potential for liability, as between shareholders in a joint venture company, than is traditionally considered to be the case under English law;

- the process of due diligence and negotiation of warranties can sometimes be a vexed issue; although practices are converging, a conceptual difference is that, under English law, a seller has no basic obligation to disclose adverse matters (subject to misrepresentation) but a more positive implied duty to disclose information may exist under civil law systems;
rights of termination will depend on the terms of the contract under English law, but some civil law systems have a more general right of termination, for cause, in the case of a long-term agreement;

at the structural level, we have seen that civil law systems may make greater use of partnerships in planning joint venture structures than in the UK;

the relationship between the contractual shareholders’ agreement and the relevant constitutional documents always requires close attention; as a generalisation, more provisions may be included in the constitutional documents under civil law systems than in their UK counterparts (one reason being that, under many civil law systems, breach of the shareholders’ agreement may give rise only to a claim for damages rather than a remedy of specific performance or injunction);

more regulated procedures exist under some civil law systems for valuation of contributions in kind and, in some countries, more formal requirements for notarisation of corporate documents.

These differences must be taken into account. However, the central commercial issues remain the same. Practices and solutions for dealing with these issues in joint venture documentation are converging internationally.

**Issues affecting emerging markets**

A common form of international joint venture is where a ‘foreign’ party combines with a ‘local’ party in order to undertake a joint venture business based principally in that ‘local’ jurisdiction. Many of these can be somewhat artificial ventures and end in failure. They require careful preparation and assessment. Issues that often need to be addressed in ventures in emerging market jurisdictions such as eastern Europe, Russia and Asia include the following.

- Structure. What types of legal structure are available for the joint venture vehicle?

- Tax. What are the basic corporate tax rates applicable to the operations of the joint venture? What are the rules permitting deduction or set-off of losses and expenditure? Are tax-free ‘holidays’ or enterprise zones being offered to encourage investment?

- Restriction on foreign participation. Are there restrictions on foreign participation (including the percentage size of any shareholdings) in particular industries?

- Licensing/regulation. Are there any foreign investment or other governmental approvals required for the participation by the foreign
party? Who should make the necessary application? What documentation (eg feasibility study) is required? How long is the approval procedure likely to take?

• Exchange control restrictions. Are there governmental or central bank approvals required in relation to the ‘foreign’ acquisition of shares – or the payment by the joint venture company (JVC) of management charges or the price for raw materials or goods supplied by the ‘foreign’ party? Are there restrictions on the conversion of the local currency into hard currency and the use of hard currency for dividend payments?

• Real property/land rights. Is relevant property owned by the state? What are the nature of land rights held by the local party or planned to be vested in the JVC? Are these limited in time or subject to restrictions or potential withdrawal? How are any land rights contributed by a local party to be valued?

• Environmental laws. What regulations apply to control environmental pollution or abuse? What powers does any governmental authority have to require clean-up or to impose fines or damages? What approvals are required for any new plant?

• Capital requirements. Are there any minimum capital requirements or any maximum debt/equity ratio? Does a capital contribution require registration with any governmental authority? Does a non-cash capital contribution require valuation by a governmental authority or an independent valuer?

• Management structure. Are there any specific laws or practices which designate the form of management structure? Is there any requirement that a particular management post (eg general manager or chairman) must be occupied by a national of the local jurisdiction?

• Technology transfer. If the foreign party is to contribute technology or know-how, are there restrictions on such an arrangement – particularly as regards royalty payments? Can restrictions on use be imposed or enforced by the ‘foreign’ party after termination?

• Employment laws. Are there any material employment laws, such as laws relating to minimum wages; consultation or approval procedures before making any redundancies or dismissals; requirements for employing local staff or management; requirements for compulsory pension reserves or medical costs; or immigration laws affecting secondments or employment from the ‘foreign’ party?

• Intellectual property rights. Are intellectual property rights (IPR) capable of effective protection and enforcement in the local jurisdiction? Is the local jurisdiction a party to international conventions recognising IPR created in another country?
• Liability. Will the joint venture ‘parent’ have any specific liability under the local laws for the actions or obligations of the local JVC?

• Governing law. What will be the governing law? There will often be pressure to adopt the national law (eg in China it is compulsory to adopt Chinese law) although this need not always be the case. There may sometimes be a trade-off with the choice of place of arbitration (or institutional arbitration). Exceptionally, parties may wish to make reference to ‘general principles of law’ or by giving the arbitral tribunal power to act as *amiables compositeurs* – although these formulations lack certainty and should only be used as a last resort.

• Dispute resolution. Is there any standard practice as to form of dispute resolution for joint ventures in that jurisdiction? Is arbitration in a venue outside that jurisdiction acceptable? Is the local jurisdiction a signatory to the New York Convention?

• Exit strategies. What restrictions are there on the ‘foreign’ party’s ability to transfer or redeem its equity freely? Will a foreign party be able to extract value on a liquidation?

International joint ventures in emerging markets require considerable preparation by the parties (and their advisers). The foreign investor should carefully consider at the outset whether the choice of the joint venture option is the right one. A realistic review of the venture’s likely cash flow and funding options will also generally be vital – including consideration of the position if the venture proves not to be commercially viable. Exit strategies will be important, including whether there should be a right to terminate the venture if it fails to meet a predetermined level of profitability.
4 Tax planning

While the initial impetus for a joint venture will come from commercial factors, tax planning can play an important – and often essential – role at the structuring stage. Even within Europe, disparities in tax systems still exist and are likely to continue for the foreseeable future. These include differences in corporate tax rates, specific tax reliefs or incentives, relief for interest payments and the imposition of local taxes on profit repatriations. An international joint venture calls for careful co-ordination and integration of tax advice involving different tax jurisdictions.

Tax considerations will always depend upon the tax profile of the parties concerned. The following discussion assumes the choice of a JVC and touches briefly on some key issues.

International joint ventures

In structuring an international joint venture, important tax objectives which need to be considered include:

• identifying the most tax-effective type of joint venture vehicle. This may include comparing a corporate structure with a tax transparent vehicle such as a partnership;

• establishing the taxable entity, if a JVC, in a jurisdiction where the basic corporate tax levels are acceptable (taking into account any tax ‘holidays’ or incentives);

• minimising the tax costs of formation. This may involve establishing the JVC in a way which avoids tax on capital gains arising on disposal of assets or shares contributed to the JVC;

• maximising tax reliefs for financing costs. This will generally mean locating debt finance in a territory where tax on profits can be relieved at the highest possible rate, subject to relevant ‘thin capitalisation’ rules and other local restrictions;

• minimising tax on the repatriation of profits from the JVC. This may be done, for example, by identifying a jurisdiction with double tax treaties which result in a nil or an acceptable level of withholding tax on dividends, interest or royalties – not only on payments to the parents by the JVC but also to the JVC from its operating subsidiaries.

It may be advantageous, in an international joint venture, for a JVC to be located in a different jurisdiction from that of either of the joint venture parties. Much will depend on the tax profile of the participants. There are now a number of European countries (including the UK) which offer attractions as the location for European headquarters. Many countries offer ‘participation exemption’ regimes which essentially exempt from local taxation foreign earnings from interests in overseas subsidiaries.
These earnings may be passed through to another EU member without additional tax. The Netherlands has, for example, been particularly successful in attracting companies due, no doubt, in part, to its favourable tax regime. Tax will, of course, only be one of the factors in choosing the location of an international JVC.

**Establishing the joint venture**

Tax planning is vital at the initial stage where a joint venture party transfers existing activities or assets (including shares in other companies) to the JVC. Tax issues will often dictate whether to transfer an existing business itself or to transfer one or more subsidiaries carrying on that business.

In 1990, the EC Mergers Directive introduced some direct tax neutrality for the establishment of joint ventures in Europe. The directive has resulted in some useful tax reliefs for EU companies that assist the transfer of a trade into a European joint venture on a tax-neutral basis if certain conditions are met. Domestic reliefs and exemptions will, however, continue to be relevant for most joint ventures – even those involving more than one European jurisdiction.

**Transfer of a business**

Several important issues must be considered when a business is transferred to a JVC:

- the transfer of capital assets (eg goodwill and land) to the JVC may give rise to tax on chargeable gains on a disposal by the transferor. Careful tax planning will be required. This might result in the business being contributed by a transferor which has available capital losses, or can take advantage of rollover relief against new assets, or which satisfies the conditions for relief introduced under the EC Mergers Directive for transfer of a trade between companies in different member states within the EU;

- similar tax planning may be appropriate to reduce or eliminate any balancing charge (recapture of depreciation allowances) arising on the disposal of plant and machinery or other assets for which capital (depreciation) allowances have been received;

- the transfer of assets may give rise to a liability to account for VAT. Questions of registration and the recovery of VAT incurred need to be considered. Where a business is transferred as a going concern, relief will frequently (but not invariably) be available;

- stamp duty (presently at a rate of up to 4 per cent in the UK) may be chargeable on the transfer of certain assets (eg land, debtors and contracts) and can be a significant cost; tax planning should be considered.
Transfer of a subsidiary
A number of the above points also apply when the relevant trade is transferred to a new subsidiary and the latter is transferred to the JVC. Tax planning will be needed to ensure tax neutrality on the transfer of the trade itself (the EC Mergers Directive does not apply to domestic transfers) and the transfer of the subsidiary. Rollover relief may be available on a share exchange and further changes in UK law may enable such transfer to be exempt from tax on capital gains. Further, where an existing subsidiary is put into a joint venture:

• unwanted assets should be extracted at an early stage to achieve the lowest tax cost while the subsidiary is within the parent’s capital gains group;

• in the UK, if assets have been the subject of an intra-group transfer to the subsidiary within the previous six years, a ‘degrouping’ charge can arise on the deemed disposal when the subsidiary is transferred out of the group and into the JVC. Where each party is contributing an existing subsidiary to the JVC, advantage can often be taken of an important UK statutory exception for certain joint ventures. This exception is likely to remain material even if certain proposed changes to UK law on degrouping come into force;

• the subsidiary leaving the parent’s group can also affect the continuing availability of trading losses. This is important if a loss-making subsidiary is being contributed; and

• there will normally be a stamp duty charge on the transfer of shares of any UK subsidiary, although there may be scope to mitigate this by careful planning.

These factors demand a careful review of the opportunities for minimising tax when existing activities are to be contributed to a joint venture. Tax planning can be crucial at this stage.

Relief for joint venture losses
The tax rules on relief for losses can be a particular concern on the establishment of a corporate joint venture. Flexibility may make a contractual or partnership joint venture structure attractive. One advantage of a non-corporate structure is often fiscal transparency. With proper planning, this may enable immediate relief for losses to be obtained in the territory of the parent. Losses in a JVC, on the other hand, can be trapped. Relief may be limited to carry forward of those losses against future profits of the JVC (sometimes indefinitely, but sometimes for a limited period).
If relief for losses is to be obtained on a current year basis, the JVC will need to be established in a jurisdiction where those losses can be relieved against the local profits of the joint venturers. (In the UK, for example, this may be possible through consortium relief. This is an important relief for many UK joint ventures: particularly 50:50 ventures where other ‘grouping’ reliefs are not available. A proportion of trading losses, excess capital allowances and excess interest expense may be surrendered by or to ‘consortium companies’. The share of losses is determined by reference to the member company’s share of the consortium. The relevant loss may only be set against profits of the corresponding accounting period of the company to which the amount is surrendered. A company is a member of a consortium if it holds 5 per cent or more of the ordinary share capital of a consortium company; a consortium company is a company at least 75 per cent of the ordinary share capital of which is owned by companies each owning at least 5 per cent of that ordinary share capital and which is not a 75 per cent subsidiary of any other company. It is no longer necessary that all members of the consortium must be UK tax resident.)

**Repatriation of profits**

The repatriation of profits often causes difficulty. Distortions can arise in a joint venture between a company from a country which operates a classical system of taxation and one from a jurisdiction with an imputation system. Moreover, imputation systems within Europe are by no means harmonised. These systems generally apply fully only between residents in the same jurisdiction and not to foreign shareholders.

The ingenuity of tax advisers has led to joint venture structures which attempt to minimise tax costs arising in respect of the repatriation of profits by establishing ‘income access’ or ‘stapled stock’ arrangements whereby:

- a parent joint venturer has primary dividend access to profits of a subsidiary of the JVC resident in the joint venturer’s own tax jurisdiction rather than for such profits to be routed, less efficiently, through a foreign holding company;

- the parent’s dividend entitlement from the JVC itself is correspondingly reduced; and

- the income access share in the JVC’s subsidiary and the parent’s shares in the JVC itself are ‘stapled’ so that they cannot be held by separate owners.

Public examples of such structures include the Anglo-French merger of Wiggins Teape and Arjomari, the UK-Dutch merger of Reed International and Elsevier and, more recently, the UK-Australian mergers of RTZ and CRA and of GKN’s support service activities with Brambles.
The same techniques can be applied to joint ventures where particular parts of the parents’ overall businesses are combined.

In simple terms, a structure designed to provide income access for a joint venture between UK and German joint venture parties through a Netherlands JVC might look like the following diagram:

Such structures need careful planning. UK corporate laws permit great flexibility in rights attaching to shares. In other European jurisdictions, care is needed to tailor the income access share to local law requirements.

Harmonisation of direct taxes in the EU shows little sign of gathering momentum. The international double tax treaty network is still incomplete. The costs (and frequently the viability) of international joint ventures will continue to be affected significantly by tax considerations. As a consequence, the international tax lawyer will continue to have an important role in structuring cross-border joint ventures.
5 **Competition and regulatory controls**

Competition and regulatory controls can have a vital impact on the establishment of joint ventures. They significantly affect the nature of conditions precedent required for the implementation of the venture, timing considerations and, not infrequently, the basic structure and viability of the joint venture itself.

Joint ventures, by their nature, commonly involve collaboration between actual or potential competitors in a way which restricts their independent freedom of action. Competition authorities will therefore be concerned to ensure, broadly, that the benefits to the public of such a collaboration outweigh the apparent detriments flowing from a reduction in competition. Joint ventures which operate in the EU may be affected both by national competition laws and EC competition laws. The interface between these regimes is still developing.

**EC Merger Regulation**

EC competition laws potentially apply to most categories of joint ventures – either through the Merger Regulation or under article 81 of the EC Treaty.

The Merger Regulation applies to joint ventures which are jointly-controlled, constitute ‘full-function’ ventures and have a Community dimension. Full-function joint ventures result in a permanent structural change in the market. They are defined as those ‘performing on a lasting basis all the functions of an autonomous economic entity’. A joint venture will be full-function if it has ‘sufficient financial and other resources including finance, staff and assets (tangible and intangible) in order to operate a business activity on a lasting basis’. A joint venture will not be full-function if it remains dependent on its parents’ activities and does not have independent access to the market – although some dependence on the joint venture parents for an initial start-up period should not affect its full-function nature.

**Community dimension**

The Merger Regulation applies essentially to large-scale joint ventures which exceed certain jurisdictional thresholds:

The jurisdictional thresholds for a Community dimension are satisfied if:

- the combined aggregate worldwide turnover of the parties exceeds €5bn (approximately $4.6bn); and
- the Community-wide turnover of each of at least 2 parties exceeds €250m (approximately $230m),

unless each of the parties achieves more than two-thirds of its aggregate Community-wide turnover in one and the same member state.
The turnover of the joint venture parents (and the whole of the respective groups to which they belong) must be taken into account for this purpose. The effect of the Community dimension test is that the Merger Regulation can apply to joint ventures between large-scale parents even though the particular venture has relatively little application to the EU and may even be small-scale. The European Commission is undertaking a further review of the jurisdictional thresholds.

**Notification and review**

Full-function joint ventures exceeding these levels must be notified to the Commission within one week of signing. Fines can be imposed if effect is given to the joint venture before it has been cleared. The preparation of a notification (Form CO) can involve considerable time and cost. The Commission may – after further investigation – block concentrative joint ventures which have a Community dimension and which are not ‘compatible with the common market’. The essential test is whether or not the concentration creates or strengthens a dominant position in the common market (or a substantial part of it) thus significantly impeding effective competition.

Full-function joint ventures falling under the Merger Regulation which have co-operative aspects will also be assessed by reference to the criteria applicable under article 81. These aspects may include: non-compete restrictions extending to the activities of the parties outside the scope of the joint venture; provisions giving rise to territorial restrictions in neighbouring markets; provisions imposing exclusive purchase, supply or licensing obligations; and any post-termination restrictions on the parties.

A venture falling within the Merger Regulation will in theory be subject solely to the one-stop jurisdiction of the Commission and not (except in

A Community dimension also arises under an alternative test if:

- the combined aggregate worldwide turnover of the parties exceeds €2.5bn (approximately $2.3bn); and
- in each of at least 3 member states, the combined aggregate turnover of the parties exceeds €100m (approximately $92m); and
- in each of at least these 3 member states, the aggregate turnover of each of at least 2 of the parties exceeds €25m (approximately $23m); and
- the aggregate Community-wide turnover of each of at least 2 of the parties exceeds €100m (approximately $92m),

unless each of the parties achieves more than two-thirds of its aggregate Community-wide turnover in one and the same member state.
limited circumstances) the jurisdictions of national competition authorities. In practice though, the Commission's jurisdiction may remain uncertain until a comparatively late stage in the process, so the implications of the jurisdiction of national authorities often need to be addressed in parallel.

The Commission must reach its preliminary decision within one month from the effective date of notification, although this deadline may now be extended to six weeks if the parties submit remedial undertakings intended to form the basis for a clearance decision. A large percentage of cases are cleared at this initial one-month stage. However, the Commission may decide to commence an in-depth Phase 2 investigation which can last a maximum of a further four months – and can therefore have a significant effect on the timing of a joint venture transaction.

**Article 81: non ‘full-function’ joint ventures**

Many joint ventures will not constitute ‘full-function’ ventures. These (eg collaborative ventures) may fall under article 81(1) of the EC Treaty which prohibits ‘agreements between undertakings which may affect trade between member states and which have as their object or effect the prevention, restriction or distortion of competition within the common market’. A joint venture which falls within article 81(1) and which is not exempted under article 81(3) can incur potentially severe consequences. Its relevant restrictive provisions are void and unenforceable. The joint venture parties risk significant fines. They may also be subject to action by aggrieved third parties in national courts.

The Commission has said that, for article 81(1) to apply to a joint venture, the parent companies must be actual or potential competitors. A review of the market in which each of the joint venturers operates and the market share of each should be carried out early in the transaction to identify any potential problems. In general, the question is whether each of the parties has, or would have had, the financial, technical and commercial resources to enter the market alone, at least in the medium term.

**Appreciable effect on trade and competition**

Article 81(1) will only apply to a joint venture where there is an appreciable effect on trade between member states and on competition. Guidelines introduced by the Commission on ‘horizontal agreements’ indicate that the following will normally fall outside article 81(1):

- purchasing joint ventures where the combined market share of the parties is less than 15 per cent; and

- sales joint ventures (which do not involve price-fixing) where the parties’ combined market share is also below 15 per cent.
Minor agreements which fall outside article 81 also include any other ‘horizontal’ joint venture where the market share of the parties in the product or service which is the subject of the agreement is less than 5 per cent (or 10 per cent in the case of a ‘vertical’ joint venture). In addition, the Commission will rarely intervene under article 81 where only small and medium sized enterprises (SMEs) are involved. The Commission considers that SMEs are rarely capable of affecting trade between member states and competition even if the above thresholds are exceeded.

Exemption under article 81(3)
The Commission has issued certain block exemption regulations (which cover, for example, some specialisation and R&D agreements) that grant automatic exemptions to agreements whose restrictive elements are no wider than those specified in the relevant block exemption regulations.

Joint venture arrangements may presently be notified to the Commission for individual exemption pursuant to article 81(3). The Commission has historically recognised that co-operative joint ventures will frequently help participants to pursue pro-competitive goals, such as research towards and development of new or improved products and processes, penetration of new geographical product markets, specialisation of production, modernisation of equipment or the restructuring of declining industrial sectors. It has therefore frequently granted individual exemptions (reviewable after a certain period) where the benefits to consumers have clearly outweighed the anti-competitive features of a joint venture.

Under current practice, the Commission will usually inform the parties in writing within two months of notification whether or not the agreement concerned gives rise to serious doubts about its compatibility with EC competition rules. The Commission is not bound, though, by any legal deadlines for adopting a decision. Following its assessment of the case, the Commission will typically adopt an administrative letter – known as a comfort letter. Comfort letters have no legal status but a court or tribunal is likely to consider them persuasive if disputes subsequently arise in national courts or arbitration proceedings.

Significant changes are likely. The Commission has introduced modernisation proposals which would abolish the system for notification and individual exemption and decentralise enforcement of article 81 to national courts and authorities. This will lead to material changes – both at EU and national level. These changes are unlikely to be introduced before 2003.
National competition controls: UK
Joint ventures falling outside the Merger Regulation may need to be reviewed under national merger controls. In the UK, for instance, joint ventures may result in a merger situation qualifying for investigation under the Fair Trading Act 1973 which should be notified to the Office of Fair Trading (OFT) for confirmation that it will not be referred to the Competition Commission.

A qualifying merger exists under the 1973 Act if:

- two or more enterprises (at least one of which is carried on in the UK) ‘cease to be distinct’. This is usually the case with joint ventures which involve an existing business and a shift in the identity of those able materially to influence the policy of that business; and

- either of the following conditions is satisfied:
  
  - as a result of the merger, a UK market share of 25 per cent or more is created or enhanced; or
  
  - the gross value of the worldwide assets of the enterprise taken over, or in which a substantial interest is being acquired, exceeds £70m.

Note (below) that the assets test will shortly be replaced by a turnover test.

If the OFT believes that the implications of the merger deserve fuller investigation, the merger may be referred to the Competition Commission (CC). The CC has wide powers to act if it finds the merger is against the public interest. This can lead to a requirement to remedy undesirable consequences of the merger or even the blocking of the venture itself. Consequently, while pre-notification is not mandatory, it will often be prudent to seek prior confirmation that no CC reference will be made.

The UK government is introducing material changes to the UK’s merger control regime later in 2001. Changes to the jurisdictional thresholds are proposed. In particular, the assets test will be replaced by a turnover test based on the UK total turnover; a level of £45m is proposed. The substantive test, to be applied by the CC, will also change to become solely competition-based, namely whether the merger will result in a substantial lessening of competition in a market. A merger which results in a substantial lessening of competition may, on occasion, be judged to bring benefits to UK consumers affected by the merger. The CC will be able to clear the merger if it considers that, on balance, it should be permitted on this ground.
UK merger control does not apply to all types of joint ventures. In particular, where a start-up JVC is being established and no existing activities are transferred to it, there is no acquisition or change of control of an existing ‘enterprise’ and the 1973 Act does not apply.

Co-operative joint ventures may fall under the regime of the Competition Act 1998. The Competition Act introduced a significant change in the regulatory regime applicable in the UK to joint ventures. Although it introduced a tougher prohibition-based system, the regulatory burden for most joint ventures has been reduced. There is no mandatory public filing requirement; and the exclusion of agreements which constitute ‘qualifying mergers’ under the 1973 Act (or which do not qualify solely because of the threshold tests) is a significant relaxation in regulatory control compared with the previous regime.

**National competition controls: non-UK**

International joint ventures may be affected by the regulatory controls in a number of jurisdictions worldwide. Such a regulatory impact will occur where a joint venture is being established:

- in a foreign jurisdiction and triggers the application of local competition or other regulatory controls in that jurisdiction; or
- which involves the merger of existing businesses previously carried on, or involving significant sales, by the participants independently in a number of jurisdictions worldwide – which may trigger regulatory requirements in each jurisdiction economically affected by the joint venture’s activities.

National filings and/or approvals may therefore be required. Early analysis of the regulatory requirements, and effective co-ordination of applications and filings, can be a crucial part of the establishment of the joint venture.

**Other EU countries**

Virtually all EU countries have national competition laws. Although there has been a trend for EU countries to introduce laws modelled broadly along the lines of the Merger Regulation and article 81, there is as yet no harmonised approach. Where a joint venture affects a number of EU jurisdictions, then (unless the Merger Regulation applies) it will be necessary to review the regulatory position in each jurisdiction separately.

Mandatory pre-filing regimes (where relevant local thresholds are exceeded) exist in a number of EU countries and can apply to foreign-to-foreign joint ventures which have an economic effect in the relevant country. Germany, for instance, has a highly-developed antitrust law enforced by the Federal Cartel Office (Bundeskartellamt).
of the current regimes applicable to ‘merger-type’ joint ventures under the national merger laws of each of the EU countries is set out below.²

<table>
<thead>
<tr>
<th>Country</th>
<th>Filing requirement/ trigger</th>
<th>Timetable for clearance</th>
<th>Test for clearance</th>
<th>Mandatory/ voluntary</th>
</tr>
</thead>
</table>
| Belgium | Filing if CTO of parents exceeds €40m in Belgium and 2 or more parents have an individual TO of at least €15m in Belgium. | Stage 1: 45 days after filing  
Stage 2: additional 60 days.  
No implementation before clearance. | Whether the JV will create or strengthen a dominant position that restricts competition on the Belgian market or a substantial part of it to an appreciable extent. | Filing is mandatory within one month of the earlier of announcement of JV or conclusion of JV agreement. |
| France | Filing if (i) CWTO of all undertakings is greater than €150m or (ii) TO of at least 2 parties in France is greater than €15m. | Stage 1: 5 weeks from filing.  
Stage 2: 4 weeks to 3 months.  
Obligation to suspend JV. | Whether the JV will create or strengthen a dominant position as a result of which effective competition will be significantly impaired in France. | Filing is mandatory. |
| Germany | Filing if CWTO of parents is at least DM1,000m (€500m from 1.1.2002) and at least 1 party has a TO of at least DM50m (€25m from 1.1.2002) in Germany (there are some de minimis exemptions). | Stage 1: 1 month after filing.  
Stage 2: 4 months after filing.  
No implementation before clearance or expiry of applicable waiting period (exemption may be granted where important reasons). | Whether a JV will create or strengthen a dominant market position (statutory presumptions of dominance) which is not outweighed by improvement in market conditions. | Filing is mandatory any time before completion and implementation is prohibited before clearance (possibility of exemption for important reasons). Additional filing of completed JVs to the Federal Cartel Office without ‘undue delay’. |
| Italy | Filing if CTO of parents exceeds L730bn in Italy, or if joint control is acquired of a pre-existing company and that company has TO exceeding L73bn in Italy. | Stage 1: 30 days from filing.  
Stage 2: 45 additional days (extendible by a further 30 days where insufficient information.)  
Implementation need not be suspended unless the regulatory authority orders it. | Whether the JV will create or strengthen a dominant position in the national market in a way that threatens to eliminate or reduce competition to a considerable and lasting extent. | Filing is mandatory any time before completion. |

² Key: TO = turnover; WTO = worldwide turnover; CTO = combined turnover; CWTO = combined worldwide turnover.
Non-EU countries

Other countries worldwide have their own independent regimes for reviewing transactions which include joint ventures. In many cases, these controls will be based on competition grounds; in others, they may consist of general foreign investment laws entitling or obliging a governmental body to review any joint venture or other investments involving a foreign participant.

International regulatory lawyers will always raise warning lights where joint ventures impact on jurisdictions which involve notification regimes (where relevant local thresholds are exceeded) such as Australia, Canada, Japan and the US.

Governmental review bodies will also play a crucial role in approving joint ventures involving foreign investment in such emerging markets as China, Russia, Thailand and Vietnam and other countries in eastern Europe, Asia and Latin America.

<table>
<thead>
<tr>
<th>Country</th>
<th>Filing requirement/trigger</th>
<th>Timetable for clearance</th>
<th>Test for clearance/voluntary</th>
<th>Mandatory</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Netherlands</td>
<td>Filing if CWTO of parents exceeds NLG250m and 2 or more parents have individual TO in the Netherlands exceeding €30m (NLG66m).</td>
<td>Within 4 weeks the Director General must decide whether a licence is required. If so, an application for a licence must be made and the Director General must decide within 13 weeks.</td>
<td>Whether the JV will lead to the creation or strengthening of a dominant position that would significantly impede competition on the Dutch market.</td>
<td>Filing mandatory prior to JV becoming effective.</td>
</tr>
<tr>
<td>Spain</td>
<td>Filing if (i) CTO in Spain exceeds Ptas40bn and 2 or more parents have individual TO exceeding Ptas10bn or (ii) combined market share in Spain (or in a 'defined' market within Spain) of 25 per cent or more is acquired or increased.</td>
<td>Stage 1: 1 month after filing. Stage 2: 3 months after filing. Stage 3: 4 months after filing.</td>
<td>Whether the JV will affect the Spanish market, in particular through the creation or strengthening of a dominant position which impedes the maintenance of effective competition.</td>
<td>Filing mandatory prior to completion.</td>
</tr>
</tbody>
</table>
Industry-specific regulation
Increasingly, participants in particular industries are also subject to industry-specific licensing or other regulatory supervision both in the UK and elsewhere – particularly where previously state-owned industries have been opened up to privatisation. Joint ventures involving new entrants to these industries (or changes in ownership of existing participants) may require specific approval of a regulatory authority or confirmation that the relevant authority does not intend to revoke a licence or similar enabling permission. Examples of such industry-specific regulation commonly include sectors such as banking, insurance, financial services, utilities, broadcasting, telecommunications and newspapers.
6 Capital and funding

How is the particular joint venture to be funded, both initially and in the future? What capital structure should be adopted? The choice of funding method will be influenced by the choice of joint venture structure and the existing and future cash requirements of the joint venture vehicle - and, importantly, by tax considerations. The following discussion concentrates on the funding of corporate joint ventures and illustrates possibilities rather than specific standard solutions. The shareholders’ agreement and the JVC’s constitutional documents need to be tailored to reflect the chosen methods.

Shareholder funding options

A corporate joint venture offers the parties a wide variety of funding techniques:

- a straightforward subscription for ordinary equity shares (possibly of different classes) is the simplest and most common method for new ventures – coupled, frequently, with an appropriate level of loan capital;

- consideration for the initial issue of shares by the JVC may be cash but could also be a non-cash consideration, such as the transfer of assets to the JVC by the joint venturers or an agreement to provide technology or other assistance; many countries impose a requirement for non-cash contributions to be independently valued;

- some of the initial finance for the JVC may be injected by way of shareholder loans rather than equity; issues will include: whether or not the loan should be subordinated to the rights of third party providers of debt finance and, if so, the terms of subordination; timing of repayments (including whether repayment must be equal or pro rata between all shareholder loans); terms of any security; assignability; events of default; and the debt/equity ratio;

- many start-up or early stage joint ventures now seek funding in part from a venture capital or similar equity provider. Such finance providers will have particular objectives including negotiation of exit routes to ensure an ability to sell their investment, hopefully at a profit, within a relatively short period (routes may include: a put option; redemption or buy back of shares; a right to initiate a trade sale or public offering; rights of ‘drag-along’ or ‘tag-along’). Techniques may also be used to incentivise management or founders of the JVC.

Tax issues

The provision of loan capital (and the debt/equity ratio) will usually be affected by tax and accounting issues. Loan capital may offer attractive flexibility since loans can be repaid more easily than equity capital. The cost of providing equity capital may in some cases be greater than loan
capital since the former may attract duties on issue (although this is no longer the case in the UK, and other countries – such as the Netherlands – are progressively reducing such capital taxes). There are also significant tax differences between paying interest on loans and distributing dividends on shares; for example, a JVC may be able to deduct any interest paid on loans from its taxable profits whereas dividends are generally not tax deductible.

In addition, it may be advantageous from a tax point of view for the joint venturers to borrow the capital themselves and inject the money as equity. For example, the parties may have taxable profits against which the interest expense can be relieved whereas the JVC may, at least initially, be expected to have losses which cannot be surrendered. Alternatively, if a joint venturer is resident in a jurisdiction which has a higher tax rate than the country in which the JVC is based, it may prefer to reduce its own profits (and therefore the tax on them) by borrowing itself (rather than reducing the profits of the JVC) and thus reducing the overall tax it suffers.

Tax rules on ‘thin capitalisation’ in the relevant jurisdiction will also be relevant. These rules apply in most sophisticated tax systems. They limit the deductibility of interest where debt finance exceeds a certain ratio to equity finance and may result in interest being effectively converted into a deemed dividend or distribution for tax purposes. Interest paid to a foreign shareholder which is treated as excess under thin capitalisation rules may also be excluded from exemption from withholding tax under relevant double tax treaties. There is a wide diversity of thin capitalisation rules internationally, even within the EU.

**Outside finance**

The parties may, of course, seek to raise finance for the joint venture from outside banking or other financing sources. This itself may take several forms including bank overdraft for working capital, term loans from banks, capital market instruments, venture capital or project finance. Outside finance will be particularly appropriate where it is intended that the JVC should operate in an autonomous manner independently from its parents.

The debt funding of joint ventures frequently arises in the context of project finance – usually on a limited recourse basis whereby the debt will primarily be serviced from, and secured on, the income stream of the venture. Such finance will require careful negotiation (including between the joint venture parties who may not all have equal creditworthiness or equal status, eg some of them may be representatives of a host country public sector). Co-ordination between injection of
equity and the provision of any project debt finance will also be carefully balanced.

Banks may not be prepared to lend to the JVC at favourable rates although, to some extent, this will depend on the identity of the parties and the shareholder guarantees offered. There should normally be provisions in the shareholders’ agreement governing the scope and extent of any such guarantees, stating whether such guarantees should be given severally and providing for cross-indemnities to ensure that the residual liability is borne by the parties in the correct proportions.

**Future finance**

The parties to a joint venture should consider how any future finance is to be provided. Participants should agree in advance, as far as practicable, the time periods and monetary limits within which they are willing to be committed to provide further finance (assuming that they are prepared to be committed at all). They must also consider the methods by which finance is to be provided and the conditions under which they are required to implement these commitments. Several factors should be taken into account:

- in many start-up ventures, the parties may commit to subscribe finance in tranches over a number of years; a detailed schedule to the joint venture agreement may be used specifying the contributions, the form of financing (ie equity or debt) and the ‘trigger’ points for any calls;

- if there is to be no commitment by the joint venture parents to provide future finance, this should always be expressly stated;

- various methods of raising finance include further loans from the parent shareholders, commercial borrowings, project finance, the provision of further equity by the shareholders – or a combination of any or all of these; and

- in international joint ventures, the possibility of exchange control in one or other country impeding the execution of these commitments must be properly considered.

Where future funding is by way of issue of further shares of the JVC, the parties should make it clear by what authority and procedure the issue of further equity can be made: by unanimous or super-majority decision – or by decision of a simple majority of the board of directors? Provisions to ensure fairness of the issue price may be necessary. Calls for new equity can be a critical decision, particularly if a party is a minority. Equity funding calls can, of course, lead to changes in respective shareholding proportions if a shareholder does not take up its share. There may be a need to anticipate the effect of significant changes by
regulating in advance that certain rights (eg rights of board appointment or veto) will fall away if a party’s shareholding falls below a certain minimum percentage.

Default
If future financing commitments are central to the joint venture (eg in a start-up venture involving significant planned capital expenditure), appropriate default procedures should be considered for failure to meet funding commitments. These can include (usually in stages):

- payment of default interest;
- loss of voting or veto rights and/or rights to appoint directors of the JVC; and
- reduction (and, possibly, compulsory sale to the other joint venture parties) of the defaulter’s shareholding in the JVC – although it may be necessary to check that the terms of such provisions do not fall foul of laws against penalties and forfeiture in the relevant jurisdiction.

It may also be necessary to decide whether the non-defaulting parties should be bound to fill the capital commitment of the defaulter in the meantime.
Managing the joint venture

What corporate governance structure should be adopted for the particular joint venture?

Establishing a management structure which gives the executive management of the joint venture appropriate decision-making powers but which also protects the interests of the joint venture parents requires careful thought and balancing of interests. Those managing the joint venture will generally wish to run its business in an autonomous fashion with the minimum of parental interference (and some studies indicate that the more successful joint ventures do allow significant management autonomy). But the joint venture parents will wish to ensure that proper safeguards are in place to protect their interests in their investment.

The management structure must be tailored to the requirements of the individual transaction. In settling the right structure, much will depend upon the proportionate equity interests taken by the joint venturers. Different considerations will apply, for instance, in a 50:50 joint venture where equality of representation and voting rights is often deliberately engineered compared with a joint venture involving minority shareholders who may be relatively passive investors and/or require special protection. Balancing the respective interests of majority and minority participants is frequently a challenge.

The board

First questions to consider are: how should the board of the JVC be constituted and what decision-making powers should it have? Is it to have an active management role or is it essentially a supervisory body, consisting of representatives of the shareholder parents, reviewing overall strategy and important decisions? If it has a parental supervisory role:

- where two parties are contributing equally to the joint venture and take equal proportions of the equity, they will expect to be able to nominate equal numbers of directors. This creates equality at board level (but has an in-built potential for deadlock);

- where one party is making a significantly greater contribution than the other parties, that party will seek the final say on matters to be decided at board meetings (eg through the right to appoint a chairman with a casting vote, the right to appoint a majority of directors or the right for its nominee directors to have weighted voting rights). Where such dominance is established, the minority shareholder will nevertheless generally seek a right of veto over certain important matters within the authority of the board in order to protect its investment;

- directors appointed by each party should, broadly, have comparable status within the respective parent organisations; and
• it will often be appropriate to establish a management committee for the
day-to-day executive team – or, in certain EU corporate models, a formal
management board.

As to decision-making, much will depend on the scale of the venture, the
seniority of the directors and the management reporting lines adopted by
the shareholders. In larger joint ventures especially, there will be some
matters which the parents as shareholders regard as central to protecting
and supervising their investment. Decisions on these matters are often
withdrawn from the authority of the board of the JVC and made subject
to shareholder approval – either through the shareholders’ agreement or
(in some jurisdictions) by reference to a shareholders’ assembly or
meeting through the JVC’s articles or by-laws. The joint venturers will
therefore have the opportunity to review such matters at their corporate
level and need not rely simply on their board appointees making the
right decision.

In smaller joint ventures, the joint venturers may be happy to delegate
the responsibility and discretion for these decisions to their appointed
directors of the JVC, with provisions to ensure that such decisions
require unanimity at board level (or at least the approval of a nominated
director of each party).

Executive management
How much authority should be delegated to the day-to-day
management? How much authority should be vested in an individual
chief executive? Decisions here are essentially the same as those which
apply in establishing any corporate management team. Whilst practical
internal guidelines can usually be devised for any corporate structure,
legal issues can arise:

• if the management team is formally a management board (as in some EU
corporate models), statutory rights and responsibilities under the
relevant law must be taken into account; and

• in some EU jurisdictions, the chief executive (or equivalent) will have –
or will be expected to have – considerable formal authority to deal with
third parties.

It is not essential that management rights and responsibilities should
correspond to equity ownership. One party may be given greater rights
of management. These might include rights over appointments to
particular management posts (eg chief executive or finance director) or
rights to control decisions affecting particular technical or management
functions. On occasions, full day-to-day responsibility may be vested in
one party under a management contract with the JVC.
At the practical level, it is important that parent shareholders and the management of the JVC understand how their relationship is to be conducted: what decisions are to be referred to the parents at corporate level; what will be the reporting lines; what information and management reports are to be provided and when; and how budgets and business plans are to be approved.

It will often be desirable, or good practice, to set out terms of reference for particular members or bodies within the management structure – for instance, establishing clear guidelines or thresholds for matters which must be handled at board level or, in the case of a two-tier structure, clarifying what matters can be dealt with at the management level and what issues must be referred to the supervisory board level.

**Duties of directors**
Inherent in a joint venture is the risk that a director may face a conflict between the interests of the JVC and the interests of his appointor. A nominee director will usually be under a fiduciary duty to exercise his powers for the benefit of the JVC as a whole and not for the shareholder which appointed him. In practice, an appointee can usually exercise his powers in accordance with the wishes of the appointing shareholder provided that, in exercising those powers, he does not act blindly but considers the interests of the JVC as a whole. Difficult situations can, however, occur and it is sometimes preferable for potential areas of conflict to be dealt with at shareholder rather than board level.

Another particular problem can be the release of confidential information. If a representative director is to be free to release confidential information to colleagues in its parent company, this should generally be made clear in the legal agreements and appropriate confidentiality obligations should be imposed on the parent.

**Protecting a minority shareholder**
How can a minority shareholder be protected? In the absence of express additional rights, a minority shareholder’s rights will depend on corporate law in the relevant jurisdiction which will, in turn, depend on the extent of its shareholding.

A minority shareholder in a UK company cannot block ordinary resolutions which will be decided by majority vote (including those to appoint and dismiss directors, increase the share capital of the JVC, sanction the issue of shares, declare dividends or control the exercise of borrowing powers). Certain rules give a minority shareholder in a UK company rights in the event of unfair prejudice or oppression by the majority shareholder – but this remedy is limited and is rarely a satisfactory protection. A similar position exists in most other jurisdictions.
Accordingly, a minority shareholder is usually advised to look for express contractual protections above and beyond those afforded by statute. Much will depend on commercial negotiations. In addition to a right of board representation, a minority shareholder will consider seeking a right of veto over certain matters, including:

- changes in the JVC’s articles of association;
- new issues of share capital (including grant of share options);
- major acquisitions or disposals;
- significant changes in nature of the business of the JVC;
- capital expenditure or contract commitments in excess of pre-agreed limits;
- borrowing limits;
- dividend distribution below an agreed minimum level;
- appointment and dismissal of key management;
- material dealings with intellectual property; and
- dealings between the JVC and any of its shareholders (except, perhaps, arm’s length dealings in the ordinary course of business).

Having negotiated the matters over which the minority shareholder is to have a right of veto, it is necessary to decide whether these matters should be entrenched at board or shareholder level – in other words, whether the unanimous or super-majority approval will be required of the directors of the JVC (including the minority shareholder’s appointee) or of the shareholders (including the minority shareholder). It is usual to cover such matters contractually in the shareholders’ agreement although, in some jurisdictions, it may be appropriate to build matching safeguards in the JVC’s articles of association or by-laws.

One safeguard (particularly if limited voting rights are negotiated) is for a minority shareholder to negotiate a put option, whereby it can oblige the majority shareholder to buy out its shares in the JVC, often in accordance with a pre-determined price formula and at a defined stage. Such an option will provide greater protection against the risk of a minority shareholder being locked in if the joint venture is unsuccessful from its viewpoint.

A minority shareholder should also consider establishing a ‘tag-along’ right whereby it can oblige the majority shareholder to include the minority’s stake in any sale it makes to a third party.
Deadlock
What happens if the parties, or their nominated JVC directors, cannot agree? Deadlock can arise either in a 50:50 joint venture where the shareholder-nominated directors take opposing views or in a joint venture where a director nominated by a minority shareholder has exercised a right of veto. Similarly, deadlock can arise at shareholder level over matters which have been withdrawn from the authority of the board and require shareholder approval.

Mechanisms for breaking deadlock where a business dispute has arisen tend to fall into two distinct categories: first, mechanisms intended to provide a workable solution enabling the joint venture to continue and, secondly, divorce mechanisms which accept that deadlock is irreconcilable and provide a method by which the venture terminates as a joint enterprise. Mechanisms enabling the venture to continue include the following.

• Giving a chairman a casting vote unlocks deadlock at board level but it does so by giving one party an advantage which negates the concept of joint control and is therefore not usually acceptable. One way of mitigating this effect to some extent in a 50:50 joint venture is to rotate the appointment of chairman (with a casting vote) between the parties.

• Giving a ‘swing vote’ to an additional, independent non-executive director will unlock deadlock at board level. The attractiveness of this will depend upon whether a suitable person with appropriate business expertise can be found. It may well be difficult for the shareholders to find a candidate who is acceptable to both of them. The development of an increasingly independent board may, however, be a desirable aim if there is an intention in due course to develop the JVC for subsequent flotation as an independent public company.

• Referring matters in dispute to an independent third party will unlock deadlock at both board and shareholder level. This could be an expert in the relevant field or an arbitrator or could involve mediation or some other form of alternative dispute resolution (ADR) procedure. Leaving matters to be decided by third parties in this way is usually inappropriate to resolve more basic differences in approach between the parties (over future funding, for example, or the strategic direction of the business). On occasions, use of a mediation procedure may usefully be employed in some emerging market joint ventures where cultural differences may play a part in disputes.

• A residual method, which is nevertheless often the most practical one, is for unresolved deadlock issues to be referred to the chairmen or chief executives (or, sometimes, an executive panel) of the parent shareholders.
It may be that they too are unable to agree – but the main advantage of
this method is that the threat of unresolved issues being escalated to the
highest authority within the joint venturers’ organisations will
concentrate the minds of the JVC management on finding a solution for
themselves.

If a genuinely insoluble deadlock arises, it will rarely be possible to
continue with the joint venture. The parties should decide in advance
what will happen in those circumstances. Divorce measures include the
following.

• Transfer of shares to a new joint venturer. An aggrieved party may wish
to ‘get out’. In some structures, an insoluble management deadlock may
act as a trigger enabling the aggrieved party to make an otherwise
prohibited transfer of its shares to a third party (subject, of course, to any
agreed pre-emption procedures). If a suitable new joint venturer can be
found, this allows the joint venture business to continue rather than be
wound up.

• ‘Shoot-out’ procedures. One increasingly common route – often
discussed if rarely used – is for an insoluble deadlock to trigger a so-
called Russian roulette or ‘shoot-out’ procedure which allows a party to
offer to buy the shares of the other party at a certain price but run the
risk of having to sell its own shares to the other party at the same price.
(This procedure is described in further detail below.) Other ‘shoot-out’
variants exist. The use of this type of procedure ensures that the business
of the joint venture will continue. It is one way of resolving the deadlock,
although the trigger must be carefully defined in order to avoid potential
abuse.

• Voluntary liquidation. Where the problems of the joint venture have
proved intractable and neither party wishes, or is required, to acquire the
other’s shares, there is little option but to bring the joint venture to an
end and wind up the JVC. (In some cases, a party could bring a unilateral
action for winding-up a 50:50 joint venture in the UK on the ‘just and
equitable’ ground.) In such circumstances, the assets of the JVC are sold
and the joint venturers will share the proceeds according to their
respective equity interests. If this stage is reached, it may be worth
considering first a compulsory auction of the JVC’s assets with each of
the joint venturers entitled to make bids for them to a person acting as
auctioneer (an ‘auction shoot out’). On occasions, the parties may have
pre-agreed plans for distribution or break-up of the JVC’s assets upon
termination.
None of these alternatives is an ideal solution. Some commentators consider that establishing a joint venture with the potential for deadlock deliberately built into the structure is, in fact, itself the best way of encouraging the parties to reach agreement on a commercial solution. The dire consequences of an insoluble deadlock on the ongoing business (to the detriment of both parties) will generally ensure that a sensible compromise is reached.

In practice, any deadlock or exit provisions in the joint venture agreement usually serve as a backdrop to a commercial arrangement to be negotiated between the parties. Even if they are not operated, such provisions will nevertheless be important when each party establishes its tactical and negotiating position if these circumstances arise.
Although the parties may be reluctant at the inception of the joint venture to discuss the possibility of its termination, a well-prepared joint venture should provide for that possibility. There are four basic scenarios:

- one party simply wanting to exit by selling its shares: ‘I want out’;
- a fundamental management deadlock (see earlier): ‘we cannot go on like this’;
- the occurrence of a specific event (eg default, liquidation, change of control, completion of project or loss of a fundamental licence) which the parties have pre-agreed will give rise to automatic termination or to a party’s right to institute a termination procedure: ‘we’ve agreed that this event should end our relationship’; and
- the JVC may become insolvent or forced into liquidation: ‘it’s all over, we’ve failed’.

Transfer of shares

A party entering into a joint venture does not normally expect to have the right to dispose freely of its shareholding to a third party since such a disposal might throw together incompatible joint venturers. It is therefore common for joint ventures to include contractual arrangements whereby:

- the transfer of shares is either restricted indefinitely without prior consent of the other party (which may not be an acceptable formula in some jurisdictions) or prohibited for a stated period or made subject to board approval; or
- the transferability of shares to a third party is not prohibited but the other shareholder is given a pre-emption right (ie a right of first refusal).

Pre-emption rights can raise particular difficulties concerning price since, by the very nature of a joint venture, shareholdings in a JVC may have no easily established market value. There are different methods of fixing the price. It may be set by reference to a price which an identified bona fide third purchaser is prepared to pay (the continuing party having a right to match that price: ‘a right of first refusal’). Alternatively, the price may be proposed by the selling party before it finds a third party purchaser at that price. In this case, should the non-selling joint venturer have a right to call for a fair price to be fixed by an expert? If so, what criteria (if any) should be set for fixing the price? Should it be determined by a price earnings ratio, or a net asset test, or should the expert simply be left to consider all the factors he deems relevant? Should the price per share be fixed by reference to a pro rata share of the market value of the JVC as a whole – without any discount or premium.
attributable to the size of the holding being transferred? Should either party have a right of revocation when the expert’s price is known?

Other points on transfer which should be considered by the joint venture parties at the outset include:

• should intra-group transfers be permitted?
• should a transfer to a third party without the consent of the other joint venturer be allowed? If not, should the first joint venturer have a right to call for the liquidation of the joint venture if consent to such a transfer is withheld?
• should partial transfers be permitted – or only the disposal of a party’s entire holding?
• is it appropriate to have an initial period during which transfers are prohibited in order to establish commitment to the venture?
• is it practicable to require a third party purchaser to be identified (ie for a sale to be a real possibility) before the pre-emption right is offered to the other joint venturer? If not, should the other joint venturer be given a second bite at the cherry if, not having exercised its pre-emption right at the outset, it wishes to do so when the identity of the chosen buyer emerges?
• is it likely that antitrust or other regulatory issues will affect any transfer?
• if a majority party wishes to sell, should it be entitled to ‘drag along’ the minority party – and/or should the minority party have the right to ‘tag along’ by requiring that the third party offer extends also to the minority party’s share in the JVC?

These transfer provisions are important. Even if they are rarely followed fully in practice, they provide a background against which the joint venture parties will often negotiate an agreed arrangement.

‘Shoot-out’ procedures
Where it may be difficult to find a third party purchaser or where a speedier and perhaps less disruptive solution to the business of the JVC is required, the joint venturers may wish to consider another alternative. A Russian roulette or ‘shoot-out’ formula is sometimes suggested. This gives party A the right to offer to buy the shares of party B at a price of its own choice. B must then either accept or reverse the process by buying the shareholding of A at the identical price. The risk of reversal acts as an inducement for A to put forward a fair price.
Russian roulette should be used with extreme care. It works reasonably well in a two-party venture if the parties’ shareholdings are roughly equal and if there are no other restrictions affecting a party’s ability to buy, such as restraints on foreign ownership or adverse tax consequences. A disadvantage is that, where one party is in a stronger financial position than the other, it could invoke the Russian roulette procedure in the knowledge that the other could not fund a counteroffer. Equally, owing to the uncertainty of outcome, it is not appropriate where a party definitely wants to get out of the venture’s business. The conditions for the ‘trigger’ entitling a party to initiate the process need also to be carefully defined.

Another variant is the so called ‘Texas shoot-out’ where, if each party wishes to buy the other out, a sealed bid system (or sometimes an auction) is put into operation whereby the party which makes the highest bid is entitled to buy out the other’s interest in the JVC. Other mechanisms exist – many perhaps a little too imaginative to be practical.

**Change of control**

There is, of course, no transfer of shares in the JVC if one of the participants is acquired by a third party or if ultimate control of that participant changes. A change in control could bring about an unacceptable situation. In such circumstances, it may be desirable to give a party rights to acquire the changed party’s holding or to dispose of its own holding – or to bring the joint venture to an end by liquidation. A clear definition of ‘control’ for this purpose is obviously necessary.

However, change of control provisions are not always appropriate. Other factors should be taken into account – such as the possible implications of such a provision operating as an improper ‘poison pill’ against an unwelcome third party bid; the duty to shareholders to ensure a full price on disposal; and the fact that (at least at present) a UK quoted company may be more vulnerable to a hostile takeover than some of its European counterparts. The valuation mechanism for establishing a fair price also requires careful structuring in these circumstances.

Even more sensitive can be the question of whether pre-emption provisions on transfers should apply if a takeover bid for one party is made by the other joint venture party itself! The existence of such a pre-emption obligation can be a restrictive factor on a party’s choice of action in the face of an unwelcome bid from this source.

**Termination events**

It is important to identify from the outset if there are any specific events or circumstances which it is pre-agreed will terminate the joint venture or give a party a right to terminate. These events commonly include:
• the expiry of a definite term – for example, a certain number of years or the completion of a particular project;

• the insolvency of a party, although it may be more appropriate in such circumstances to grant the other party a call option to allow that party to buy the insolvent party’s shares in the JVC;

• the change of control of one of the joint venture parties (again a call option will generally be appropriate); and

• a material breach by one joint venture party of the terms of the joint venture agreement (or material ancillary contracts) which the ‘innocent’ joint venture party elects to treat as a terminating event.

Apart from a transfer of shares, the only practical way to end a corporate joint venture is for the JVC to be wound-up and for its various assets to be sold (possibly by an auction to the shareholders) or distributed or both.

Consequences of termination
Factors which will invariably have to be considered upon any termination (including upon any transfer of shares) include the following.

• Should any non-compete undertaking continue, at least for a period, after termination or transfer?

• Confidentiality undertakings relating to the affairs of the JVC or the other parties should normally continue.

• Will loans from the outgoing party be repayable by the JVC upon a party’s exit or required to be assumed by the continuing or incoming parties?

• Should it be a requirement that the transferee must assume the outgoing party’s obligations under any guarantees or counter-indemnities given for the benefit of the JVC?

• It will be important to review any ancillary contracts (for example, licences or supply contracts) to decide whether a party should have a right of termination, or perhaps to require re-pricing, in the event of one party leaving the joint venture.

Intellectual property
It is particularly important to establish what will happen to a JVC’s technology and other IPR if the joint venture is wound up or there is a transfer of shares. Points to consider include whether:

• ‘foreground’ rights, assigned initially by the joint venture parties to the JVC, should be reassigned to them respectively on termination;
• the JVC should be required to give up or change its corporate name or other trade marks if they incorporate ‘house’ names or marks of an outgoing party;

• each party should be free, upon termination, to use and exploit any ‘arising’ intellectual property generated during the course of the joint venture; and

• on a transfer of shares, the outgoing party should lose the benefit of any licence of intellectual property from the JVC – or only the benefit of rights generated in the future.

These points are often neglected at the outset; they should not be.
9 Planning the joint venture

The lawyers’ role
Business factors provide the reasons for any joint venture. These factors must therefore lead the transaction. The role of the lawyer is to help structure the joint venture to achieve the business objectives; to alert the business negotiators to important legal issues and the options available; to carry out appropriate legal investigations; to help in obtaining necessary clearances and consents; and to ensure that the joint venture is properly and clearly documented and that the interests of the client are appropriately safeguarded. Each joint venture will be different. Many will take a considerable time to crystallise. A wide range of legal issues may need to be dealt with.

Confidentiality
The joint venture parties should put in place appropriate confidentiality agreements before initial financial data, technical information and other details are exchanged in preliminary negotiations.

Memorandum of understanding (MoU)
An MoU, or heads of terms, will often start off a joint venture. Particularly in cross-border transactions, an MoU helps to:

• confirm the fundamental intentions of the parties;
• enable the senior negotiators to concentrate on establishing the fundamental principles of these often complex deals;
• provide a basis for any public announcements or approaches to initiate regulatory clearances; and
• keep things moving generally.

Lawyers generally advise against MoUs being legally binding, as they are not sufficiently certain or comprehensive. Exceptions should normally be made in the case of confidentiality provisions and any exclusivity commitment by a party not to negotiate a deal involving the same business with any third party for a certain period. English case law has confirmed that such lockout agreements can create legally binding obligations. Agreements to negotiate will not, though, be enforceable under English law; on the other hand, under many civil European laws, such MoUs can still give rise to liability for compensation if a party does not proceed in good faith with genuine negotiations.

An MoU is therefore a serious document. It should, from the lawyers’ viewpoint, normally address – at least in outline – the following principal issues:

• the likely joint venture structure;
• the equity interests of the parties;
• initial capital and any commitments to future financing;
• the board, management and voting structure;
• decisions requiring consent of the parents;
• any commitments to provide technology;
• non-compete undertakings;
• broad scope of any warranties/indemnities;
• basic exit provisions;
• conditions precedent; and
• target timescales.

Pre-contract due diligence
Due diligence and other pre-contract (or at least pre-completion) investigations are perhaps even more important in the case of substantial joint ventures than in outright acquisitions, especially where joint ventures bring together existing businesses or assets of the joint venture parties. Joint ventures involve ongoing relationships. It is commercially difficult in all but the most serious cases to pursue warranty or other claims against a co-venturer after a joint venture begins. It is far better to be thorough in due diligence investigations prior to concluding the joint venture. Such investigations should include:

• review of financial matters such as past accounts (including management accounts); valuation of the other party’s asset contribution; profitability of material contracts; intra-group management charges; accounting policies; leasing commitments; and

• legal due diligence covering: title to assets; properties (including environmental issues); litigation; terms of major contracts (including termination and change of control provisions); regulatory licences; intellectual property rights; principal employee benefits, pensions and option plans and any agreements with trade unions.

Structuring the joint venture
Careful thought must be given at the outset to the appropriate structure for the joint venture. In particular, tax and regulatory lawyers should be involved at an early stage.

Accounting issues
It will also be important to determine the accounting treatment of the venture’s financial results in the accounts of the parents. While proportional consolidation on a line-by-line basis in the accounts of the
parents is generally recommended by international accounting standards (IAS), the UK still applies the equity method of accounting to corporate joint ventures unless a parent venturer has majority voting rights or exercises sufficient dominant influence so as to make the JVC a subsidiary undertaking requiring full consolidation. There is no consistent approach to accounting for joint ventures internationally. In the EU, member states have the option to permit proportional consolidation for joint ventures. This option has been taken and is the more common practice in Belgium, Germany, Italy, the Netherlands and Spain. In France, proportional consolidation is mandatory for joint ventures whether or not they take a corporate form.

**Valuation issues**
Where the joint venture consists of a merger of two existing businesses, a valuation of the assets being contributed by each party will frequently be vital in justifying the equity split. The parties should agree at the outset what accounting principles will apply in valuing those assets. Completion audit or review procedures may also be necessary. In a 50:50 venture, ways of equalising the value of each party’s contribution may need particular attention; these may include differences in net asset contributions, differential entitlement to dividends or other means.

**Consents and clearances**
Similarly, it is important to establish early on the principal regulatory and other third party clearances or rulings which will be required, such as those relating to:

- competition law;
- governmental approvals;
- local/industry regulatory clearances;
- export controls;
- stock exchange requirements;
- taxation;
- major contracts/licences (eg where there are bars on assignment or rights of termination triggered by change of control);
- employee and/or works council consultation; and
- banking and financing instruments.

A critical time-path for obtaining these clearances should be established – making clear whether or not they are conditions precedent to completion. If they are not conditions precedent, provisions for
compensation may be necessary if particular consents or clearances are not obtained.

**Employee issues**
The position regarding employees needs careful attention. Are there obligations to consult or obtain approvals of employee representatives? Will existing employment contracts be transferred to the JVC under relevant employee laws? Will relevant employees remain employed by the joint venture parties with their services being seconded to the JVC? Pension rights for employees of the JVC often cause particular problems and require early analysis, particularly if it is intended that employees of the JVC should continue in existing parent schemes. The effect on existing share option rights of employees transferred to the JVC may also be material.

**Definitive legal agreements**
The next stage is for the lawyers to prepare the definitive, binding agreements. These transactions – particularly those with cross-border elements – call for clear, well-drafted documentation. Linguistic and cultural differences between the joint venture parties may cause difficulties and these will be made worse by unnecessarily complex or badly drafted documents.

The basic legal documentation in the case of a joint venture to be conducted through a corporate vehicle will usually consist of the following:

- a joint venture agreement (or shareholders’ agreement) dealing with the establishment of the joint venture and the ongoing relationship of the parties as shareholders in the JVC;
- where two businesses are being merged, a separate contribution or asset/sale agreement to deal with the transfer of the relevant businesses from the parents to the new JVC may be appropriate; this would include essential warranties and indemnities as in a conventional corporate acquisition;
- the memorandum and articles of association, by-laws or other constitutional documents establishing the JVC under the relevant jurisdiction (and requiring appropriate co-ordination with lawyers in that jurisdiction); and
- ancillary documentation such as supply and purchase agreements, management services agreements and licence agreements governing use by the JVC of proprietary technology or trade marks of the parent co-venturers.
Joint venture documentation is important. It provides the framework for the continuing collaboration between the joint venture parties. These agreements take time to negotiate and require serious management attention. The process of negotiating and agreeing the legal documentation can contribute significantly to the establishment of a firm foundation for the ongoing business relationship between the joint venture parties.
A Preparing for the joint venture: checklist

The following are legal and transactional issues to be considered at the outset of discussions regarding a proposed joint venture – in addition to issues relating to the terms of the joint venture agreement itself (see checklist B below).

1 Initial steps

Basic initial steps or questions to consider include the following.

☐ Has a feasibility study or business plan been prepared?
☐ Will confidential information be disclosed during negotiations? Has a confidentiality agreement or information exchange agreement been put in place?
☐ Is each party still free, pending signature of the definitive agreements, to negotiate with third parties an alternative or competitive deal? Should there be exclusivity obligations, preventing such negotiations, for a specified period?
☐ Is a letter of intent or memorandum of understanding appropriate to establish points of principle?
☐ Is any of the parties a publicly-quoted company with public announcement obligations or stock exchange requirements for shareholder approval relating to the venture?
☐ What material authorisations, consents, licences or other conditions precedent will be required for the joint venture to commence?
☐ If an international joint venture, consider the effect of local laws of the country in which the venture is to be established (see 3 below).
☐ What governing law should apply?

2 Structure of the joint venture

Consider the appropriate structure (note tax considerations) for the joint venture.

☐ Corporate or unincorporated venture?
☐ Limited or unlimited liability company?
☐ Contractual collaboration or alliance?
☐ Partnership? Limited partnership?
☐ Limited liability partnership (LLP)?
☐ Profit pooling or revenue sharing arrangement?
☐ European Economic Interest Grouping (EEIG)?
☐ Location of joint venture entity?
☐ Series of joint venture vehicles in different jurisdictions?
☐ Existing entity – or new entity to be formed?
3 Local law issues

Consider issues raised by local laws of the jurisdiction in which the joint venture will be principally located or undertake business.

☐ Registration requirements? Inward foreign investment review by governmental authority?
☐ Requirement for local ownership/control?
☐ Local governmental consents/licences required?
☐ Effect of local employment laws?
☐ Taxes: duties on share capital or loan capital? Withholding tax on dividends? Availability of capital allowances? Corporate tax rates? Any tax holidays or incentives? Import duties on raw materials/goods?
☐ Requirement to prepare and file publicly any corporate returns and/or accounts?
☐ Non-cash contributions: requirement for independent valuation?
☐ Currency of payments; convertibility; exchange controls?
☐ Any restrictions on repatriation of profits and/or payment of dividends?
☐ What rights in land will the joint venture obtain?
☐ Do local laws recognise intellectual property rights? Any special laws relating to transfer of technology?
☐ Any specific laws relating to joint ventures?
☐ Lawyers?
☐ Governing language for texts?

4 Contribution of existing assets

Where existing assets or businesses are being vested in the joint venture by any of the parties, consider the following acquisition-type issues.

☐ Due diligence investigation to be undertaken by either party into assets/business to be contributed by the other?
☐ Tax/transfer duty considerations affecting method and timing of contributions?
☐ Method of valuation of contributed assets? Accounting policies to be applied?
☐ Any equalisation payment required as between the parties? Method of calculation and payment?
☐ Any minimum net worth obligation on either party in respect of assets to be contributed? Any subsequent completion account adjustment as between the parties?
☐ Warranties and/or indemnities to be given by either party to the JVC/other party regarding business or assets contributed? Limits as to time and/or amount?
☐ Any material contracts/assets/properties which require third party approval prior to vesting in the joint venture?
☐ Need to provide for partial, delayed or conditional completion of asset contributions?
☐ Need for separate contribution agreement under relevant local laws?
5 Regulatory matters

Identification of regulatory issues and filings/consents required will be an important part of the initial analysis.

☐ Will the joint venture result in a significant market share in any particular market or jurisdiction?

☐ Is it a full-function joint venture for purposes of the EC Merger Regulation?

☐ Do the EC Merger Regulation turnover thresholds apply?

☐ Co-operative joint venture? Is (presently) notification to EC Commission required or desirable under Article 81 of the EC Treaty?

☐ Does the joint venture constitute a qualifying merger under UK Fair Trading Act 1973?

☐ Does the Competition Act 1998 apply? Should guidance or an individual exemption be sought under the Competition Act?

☐ Are any industry-specific regulatory approvals required?

☐ Make provision for co-operation between parties in the event of subsequent regulatory action?

☐ Any concern that the joint venture (particularly a property venture) might be a collective investment scheme under the Financial Services and Markets Act 2000?

☐ Are regulatory approvals required in any foreign jurisdictions?

☐ Should any approvals of regulatory authorities be made conditions precedent of completion/establishment of the JVC?

6 Tax

Tax considerations may play a major part in structuring the joint venture and, if so, will require detailed attention and planning. Possible issues, among many, include the following.

☐ Capital gains on contribution of assets/shares to the joint venture?

☐ Capital allowances/balancing charge on transfer of assets?

☐ Need to transfer tax losses?

☐ Stamp duty cost?

☐ Is ongoing consortium or group relief required?

☐ Do tax considerations lead to a preference for a ‘tax transparent’ structure?

☐ In the case of an international joint venture, will the structure be affected by:
  ☐ need for efficient repatriation of profits?
  ☐ thin capitalisation?
  ☐ transfer pricing?

☐ Identify tax clearances to be obtained; will any be conditions precedent of completion/establishment of the joint venture?
7 Accounting

It may be important to establish early how the joint venture will be treated in the accounts of the joint venture parents.

☐ Will it be a subsidiary undertaking (e.g., consolidation)?
☐ Will there be ‘severe long-term restrictions’ affecting a parent’s rights (which may lead to gross equity accounting in the UK)?
☐ Will it be an associated undertaking (e.g., gross equity accounting)?
☐ If it is an unincorporated joint venture, is proportional consolidation desired?
☐ Is there a need to settle agreed accounting policies and rules for the JVC?

8 Employee issues

Employment issues should be considered early. They include the following.

☐ Is there a transfer of a business? Will the Acquired Rights Directive/Transfer of Undertakings Regulations apply?
☐ Will employees be seconded to the JVC – or employed by the JVC?
☐ Are there existing share option or other incentive arrangements? How will they be affected?
☐ Are employees members of an existing pension scheme? Will there be a need for a new JVC scheme?
☐ Will service contracts be required for key employees?
☐ Will there be a need to harmonize employment terms and conditions within the JVC?

9 Intellectual property

The principal IPR issues need to be identified early.

☐ Will material technology be provided by the parties to the JVC? Is it protected by IPR?
☐ Is technology predominantly in the field of the JVC – or is it used (mainly/partly) in the separate operations of the parties?
☐ Is it preferable to vest ownership in the JVC – or to license?
☐ Will parties need ongoing access to IPR generated by the JVC?
☐ Will competition laws apply to the terms relating to IPR? Consider possible application of Technology Transfer Block Exemption?
☐ Will trade marks (including ‘house marks’) of the parents be licensed to the JVC for its use – including in its name/logo?
☐ What should be the position of rights to IPR in the event of termination?
10 Property and related services

Property and related issues to be considered at the outset include the following.

☐ Will property be transferred/leased to the JVC?

☐ Will 'site-splitting' be necessary?

☐ Will transitional arrangements be necessary to support the JVC in respect of services, property-related facilities, IT/communication systems, accounting and other professional support?

☐ Need for environmental audits? Allocation/indemnities regarding potential environmental liabilities attributable to pre-completion circumstances?
**Drafting the joint venture agreement: checklist**

This checklist addresses specific issues to be considered when drafting the joint venture or shareholders’ agreement. It assumes that a limited liability company (JVC) will be used as the joint venture vehicle. Many of the items listed below nevertheless apply, on a similar basis, to other joint venture structures.

**1 Identity of parties**

It is important to identify the most appropriate parties to the agreement.

- Parent companies to be parties – or shareholding subsidiaries?
- Parent company guarantee to be provided to support obligations by any contracting party?
- JVC itself to be a party?

**2 Conditions precedent**

Identify matters which are so fundamental that they should be pre-conditions of completing the joint venture.

- Governmental or regulatory approvals required for transfer of assets and/or establishing the joint venture?
- Licence required for the JVC to commence business?
- Third party consents required to enable key contracts, intellectual property licences etc, to be vested in the JVC?
- Tax clearances?
- Approval required from trustees of debenture stocks or under other existing financing instruments?
- Completion of due diligence by either party?
- Approval of shareholders of either party required under rules of any stock exchange?
- Long-stop date to be set for satisfaction of conditions precedent?

**3 Business of the JVC**

It is generally desirable to clarify the intended scope of the JVC’s activities.

- Objectives? Agreed business plan?
- A specific project or a continuing business?
- Any geographical limits to JVC’s business? Need to regulate exports?
- Any fundamental authorisations, consents, licences or other conditions precedent required for the JVC to commence business?

**4 Capital and funding**

A variety of important issues relate to capital and funding of the JVC.

- Authorised share capital? Number of initial shares to be issued? Fully or partly paid?
- Proportions of equity to be held respectively by the parties?
- Amount of initial investment (equity and loans) by each party?
- Payment in cash or kind (eg equipment, goods or know-how)?
Non-cash consideration to be valued? Method of valuation? Approval by any regulatory or other third party? Does s103 or s104 Companies Act 1985 apply?

Timing of payment? Committed instalments?

Shares or loans? If shareholder loans, are they to be secured? Or subordinated?

Different classes of shares to be established to reflect different interests or contributions of the parties?

Any right of a party to preferential dividends?

Future finance: any obligations on shareholders to make additional finance available to the JVC? Any limit (time/amount) to that obligation? Authority and procedure for making cash calls?

New shares to be offered to shareholders in proportion to existing shareholdings?

Any default or dilution provisions to apply if finance commitments are not met?

Obligation to give parent company guarantees to support JVC borrowings?

Provision for ensuring that any liability under such guarantees is borne in agreed equity proportions as between the parties?

Availability to the JVC of grants or subsidies (eg local development/EU grants)?

Tax considerations which affect form of financing? Are any ‘thin capitalisation’ rules applicable?

Any authorisations or consents required by a party for financial investment in the JVC?

5 Constitution of JVC

The main constitutional documents of the JVC should be identified and agreed.

Memorandum and articles of association or equivalent documents?

Table A to be adopted with specific amendments – or long-form articles of association?

Special rights to attach to separate classes of shares:
  - right to appoint directors?
  - presence in quorum?
  - voting rights?

Pre-emption provisions on transfer to be included in articles?

Registration/prior clearance with any governmental registry?

6 Board of directors

The principles relating to board and management structure should be clearly established.

Number of directors?

Number of directors to be appointed by each party?

Can the board itself appoint additional directors?
Is a two-tier board structure desirable (e.g., board of directors/management committee comparable to supervisory board/management board in some EU countries)?

Voting – simple majority/special majority? One director, one vote – or weighted voting rights?

Chairman to have casting vote?

Rotation of right to appoint chairman between the parties?

Names of first directors?

Frequency of meetings? Location?

Quorum? Length of notice of meetings? Alternates?

Authority of board representatives to bind the parent companies?

Any mechanisms for resolution of deadlock? (See also 17 below.)

Appointment of chief executive, executive directors or officers? Any rights of appointment of particular executives or management positions to attach to particular shareholders?

Autonomy of board – or are specific matters to be reserved for shareholders?

Any restrictions on voting by directors on contracts or matters in which they are ‘interested’?

Terms of reference required for chief executive/other executives?

7 Shareholder meetings

Although as a matter of law procedural details can generally be left to the articles of association, it is often easier (certainly in the case of an international joint venture) to include basic principles regarding shareholder meetings.

Quorum to require a representative of each party?

Notice of meeting? Provision for short notice? Written resolutions?

Location of meetings?

Weighted voting rights on any particular issues?

Chairman’s casting vote?

Separate class rights?

Proxies?

Shareholders’ assembly to be created for certain issues rather than formal general meeting?

8 Matters requiring unanimity or special majority

It is often of crucial importance to set out matters which require unanimity (or a special majority vote) before they can be undertaken by the JVC.

Are specified matters to require unanimity (or special majority) at board level?

Are specified matters to be reserved for unanimous (or special majority) decision by the parties at shareholder level?

What matters are to be covered:

- issue of new shares?
admission of new shareholder?
alteration of constitutional documents?
change of JVC name?
formation of subsidiaries?
loans/borrowings/mortgages/guarantees in excess of specified limits?
strategic business plan?
approval of annual budgets?
capital expenditure commitments by the JVC above specified limit?
declaration of dividends?
new types of business/geographical expansion?
any merger, joint venture or material co-operation arrangement with third parties?
acquisition/disposal of material assets or securities?
entry into or termination of other material contracts?
pricing/trading terms?
employment/removal of chief executive or other senior management?
appointment/removal of auditors?
alteration of accounting policies?
commencing/settling substantial litigation?
establishment of JVC pension scheme?
licensing of intellectual property rights by the JVC?
liquidation of the JVC? Dissolution of any subsidiary?
dealings between the JVC and any shareholder (other than trading on arm’s length terms in the ordinary course of the JVC’s business)?

Is provision necessary or desirable to deal with deadlock (see 17 below)?

9 Administrative or corporate matters

The agreement should generally deal with a number of basic administrative or corporate matters.

Registered office?
Secretary?
Form and timing of management information or other financial reporting from JVC to shareholders?
Obligation to maintain proper accounting records?
Each party’s rights of inspection of the JVC’s accounts and records?
Insurance?
10 **Profit distribution**

The parties should establish clearly the principles to apply in respect of profit distribution.

- Dividend policy? Minimum level of profits to be distributed (or retained) each year?
- How can profit distribution policy be changed?
- Provision for interim dividends?
- Any authorisations required from regulatory authorities for payment of dividends?
- Any withholding tax?
- Any need to consider establishment of a special structure (e.g., income access shares) to enable shareholder(s) to receive dividends directly from a country of an operating subsidiary of the JVC rather than from jurisdiction of the JVC?

11 **Intellectual property**

Rights and obligations of the parties regarding technology and intellectual property will often be vitally important. These may be addressed in separate ancillary agreements (to which the JVC may be a party) with the principles being set out in the main agreement. Basic issues include the following.

- Transfer to the JVC of intellectual property/technology by each party? Timing and procedure for technology transfer?
- Territorial scope? Exclusive licence to the JVC? Availability of improvements?
- Licence by the JVC to shareholders of intellectual property (and improvements) developed by the JVC?
- Arrangements for training and technical assistance?
- Rights on termination to intellectual property developed or owned by the JVC?
- Licence of a party’s trade names/product marks to the JVC?

12 **Restrictions on shareholders/parents**

Clarify the extent of any non-compete or other restrictions on the independent business freedom of the parties.

- Restriction not to compete with the JVC’s business? Territorial scope?
- Any exceptions for any existing activities of either party not contributed to the JVC?
- Obligation on parties to refer to the JVC orders/business within field of the JVC?
- Confidentiality undertaking by parties in respect of affairs and technology relating to the JVC? Similarly, in respect of affairs of other shareholders?
- Restriction on a party poaching employees of the JVC?
- How long are restrictions to apply for? Life of JVC – or limited period? For a period after a party ceases to be a shareholder in the JVC and/or the termination of the joint venture agreement?
- Parent company guarantees of performance (if not a party) by affiliates?
13 **Change of control of shareholder**

A sensitive issue is whether any rights are to be triggered by a 'change of control' of a party. If so, this needs to be clearly stated.

- Define change of control?
- Obligation to be imposed on a party, affected by a change of control, to offer to sell its shareholding interest to other party? If so, establish valuation procedure and criteria?
- Change of JVC name?

14 **Transfer of shares**

The agreement should set out clearly the rules to apply if a party wishes to 'get out' by transferring its shares in the JVC.

- Pre-emption provisions in favour of other partner(s) to be included? Right of first offer – or right of first refusal (ie is third party purchaser required to be identified by seller)?
- Can a party sell some (or only all) of its shares?
- Any minimum period during which no sales to third parties are permitted?
- Valuation procedure and formula if a party wishes to exercise pre-emption right? Guidelines as to price? (Pro-rata market value? Fair value? Discount/premium for size of shareholding?)
- Is a party free to sell shares in the JVC to a third party if pre-emption right is not taken up? Alternatively, should a party have a right to call for liquidation of the JVC if the pre-emption right is not exercised?
- Should the continuing joint venture party have a second right to pre-empt the sale if and when a third party purchaser is identified?
- Is it appropriate to include a 'shoot out' provision (eg party receiving notice must elect either to purchase shares of other party or to sell its shares to that party)?
- Should a 'tag-along' provision be included (eg transferor must require third party purchaser to offer to buy also the other party’s interest at the same price per share)? Or a 'drag-along' provision (eg selling party can oblige other party also to transfer its shares to the same purchaser)?
- 'Piggy back' rights in the event of a public offering?
- Is a party free at any time to make intra-group transfers?
- Any specific put/call options to be included at the outset? If so, what price formula and at what times can option be exercised?
- Requirement for change of JVC name if existing participant sells shares?

15 **Ancillary contracts**

Although detailed terms may be set out in separate agreements, consider whether it is desirable to refer to arrangements dealing with any of the following potential arrangements between a party and the JVC.

- Secondment of staff?
- Management agreement?
Provision of accommodation/support services/facilities?
Transitional arrangements for sharing computers, software or other IT facilities?
Transfer (sale or contribution) of business assets?
Provision of technical assistance/know-how/training?
Distributorship agreements? Supply of goods/raw materials?
Trade mark, trade name or other intellectual property agreements?

16 Termination

Exit strategies and options should always be considered.

- Fixed or indefinite term for the JVC?
- Any circumstances in which termination will automatically occur (e.g., loss of licence)?
- Right of an ‘innocent’ party to call for transfer of shares upon material breach by a ‘defaulting’ party? Or insolvency of another party (or its parent company)?
- Right of a party to give notice of termination (leading to liquidation unless otherwise agreed) after minimum period? Or is exit solely by transfer of shares?
- Arrangements upon termination/liquidation to deal with: distribution of assets; return of confidential material; disposal of outstanding orders and inventory; payment of outstanding loans; non-compete obligations; and outstanding contracts at termination?
- Rights of each party to use the JVC’s intellectual property/know-how after termination?
- Division of any other assets and liabilities of the joint venture? Any auction process as between the shareholders?

17 Deadlock

Consider whether it is necessary or desirable to develop procedures for resolving any major deadlock or breakdown.

- Need to define deadlock or breakdown?
- Reference to chairmen/chief executives of parties for ‘agreed’ resolution?
- Chairman’s casting vote?
- Independent third party (or director) to be given a swing vote?
- Reference to expert or panel of executives?
- Any mediation or other alternative dispute resolution (ADR) procedure to be developed?
- Specific right to serve notice to trigger ‘shoot out’ formula (e.g., other party must either buy first party’s shares or sell its own)?
- Specific right (after minimum period?) for either party to call for liquidation of the JVC?
18 Standard provisions

A number of ‘standard’ provisions should be considered if not already covered.

- Confidentiality?
- Costs of preparation to be borne equally? Stamp duty?
- Force majeure?
- Notices?
- Amendments?
- Assignment of rights/obligations?
- Exclusion of Third Party Rights (Contracts) Act?
- Conflict between joint venture agreement and the JVC’s constitutional documents (ie supremacy of joint venture agreement as between the parties)?
- No partnership?
- Severability?
- Entire agreement?
- Provisions relating to public announcements?
- Governing law?
- Dispute resolution: submission to jurisdiction/arbitration?