

2003

# Structuring and Negotiating International Joint Ventures: Anecdotal Evidence from a Large Law Firm Practice

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## Recommended Citation

Sanjiv K. Kapur, *Structuring and Negotiating International Joint Ventures: Anecdotal Evidence from a Large Law Firm Practice*, 53 Case W. Res. L. Rev. 937 (2003)

Available at: <https://scholarlycommons.law.case.edu/caselrev/vol53/iss4/9>

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# COMMENT: STRUCTURING AND NEGOTIATING INTERNATIONAL JOINT VENTURES:

## ANECDOTAL EVIDENCE FROM A LARGE LAW FIRM PRACTICE

*Sanjiv K. Kapur*<sup>†</sup>

First of all, I wanted to indicate my background will color some of the remarks and some of the comments I make on Rachele Sampson's paper.<sup>1</sup> I primarily do work in the cross-border transactional area. A lot of the work is in mergers and acquisitions, and some of it is in joint ventures.

In trying to think about what Rachele was saying in her paper and whether I could draw from my own experience in this area, last night I sat down and thought of the joint ventures I had been involved in within the last six to eight years. I came up with a list of twenty. Even though that certainly does not compare with the hundreds of joint ventures that Rachele looked at, it may give some anecdotal evidence of the role corporate structure and governance plays. Clearly, my limited experience does not provide scientific evidence, but it may still be useful. Before talking about my conclusions, I think that it would be useful to note a couple of differences from the data that Rachele looked at, and the data that comes from my experience.

First of all, my data set is limited in the sense that I am looking at joint ventures that came to a law firm, a large law firm as

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<sup>1</sup> See Rachele C. Sampson, *The Role of Lawyers in Strategic Alliances*, 53 CASE W. RES. L. REV. 909 (2003).

opposed to things that might have been handled by in-house counsel. So, that may explain why some of my experiences were different from what Rachelle has seen. I suspect that a joint venture has to be more complex and more monumental in scale before a company requires resources from outside and incurs the cost and retains an outside law firm to handle the matter.

The second thing that may contrast my experience from the sample Rachelle was looking at, is the areas in which the joint ventures were focused. Some of the ones that I focused upon were in the research and development context. Most of them, however, were joint ventures where some entity is trying to access a market in another country or access lower cost production in another country. Intellectual property rights and R&D are a component, but they are not the sole focus of the joint ventures.

As I was saying, I examined the joint ventures I had worked on for the last six to eight years. I actually have two ongoing projects, but I did not include them within the sample I am going to talk about today. Of the twenty joint ventures I have worked on in the last six to eight years, all but two involved equity joint ventures, which is very different from the experience that Rachelle pointed out from her studies. Some or all of the differences in our data sets I pointed to before will indicate that there may be reasons why my observations are different from Rachelle's.

I should note that the joint ventures I am currently working on might herald a new trend with respect to whether companies prefer equity joint ventures or contractual joint ventures. One of the joint ventures that I am currently working on involves Brazil and the other involves China. One probably will be an equity joint venture and the other will most likely be a contractual joint venture, and so perhaps a change in my prior experience with joint ventures in terms of the percentage that are actually equity joint ventures is being observed. But comments from practitioners in the prior panel indicate that most joint ventures on which law firms have worked on usually do involve equity joint ventures. I think there are several reasons why that is so.

First of all, there is the issue of liability. A separate entity provides a shield from liability. The most common entity used is either a limited liability company or a corporation. People want to have some sort of separate entity that can shield the operations of the two or more joint venture partners from the liabilities of the joint venture entity. Now, of course, as members of the prior panel noted, there are fiduciary responsibilities that could arise with setting up a new entity and could create more liabilities for the joint

venture partners in certain contexts, but the overriding principle is that a new entity will isolate the liabilities of the joint venture and help the joint venture partners avoid assuming these liabilities.

The second reason to have an equity joint venture is one of meeting local requirements. This is especially true in the international context; one cannot just set up businesses abroad without creating a new structure or a new entity. One actually has to incorporate or set up a limited liability company so that one can qualify to do business, hire employees, and meet local legal and tax requirements. Short of setting up a new entity, the only alternative is to qualify an existing foreign entity as operating a branch in a new jurisdiction. That usually is much more complicated, time consuming, and costly.<sup>2</sup>

The third issue that is relevant is really more of a business issue as opposed to a legal issue. A number of parties that set up a joint venture specifically want to create a separate entity. They do not want to have a contract where two partners can be adverse to each other; rather they want to create a new culture. I can convey what I mean by giving you an example. I have a German client which is a huge, multinational, multibillion dollar company. They have certain ways of doing business, but they are realizing that in this changing world, with the advent of accelerating technology and the Internet, their practices may not be ideal business practices. So, they want to create a separate entity where they can send some people and expose them to a new culture and create a new culture from which they can profit – without tainting the new venture with their “old culture” culture. This is just one example of how business reasons lead to the creation of an equity joint venture.

Another business reason is to assemble a group of people who are committed to this new joint venture. So, you put them into a new entity. Ideally, they will identify with the interests of that new entity as opposed to those of one of the partners.

An additional reason why you want to create a separate entity is based on accounting and profit allocation issues. With a separate vehicle, it is very easy for people to figure out how the profit of the joint venture will be determined and who will get credit for whatever sales or intellectual property that the joint venture creates.

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<sup>2</sup> Symposium, *The Role of Lawyers in Strategic Alliances*, 53 CASE W. RES. L. REV. 857 (2003).

And the last reason is the one that was referred to by Rachelle, which I think is an important one: that is complexity.<sup>3</sup> As you have to deal with the unknown in a complex situation, it is much easier to just set up an entity, create a governance mechanism, and let that entity go off on its own; whereas in the contractual case, you have to specify everything up front and try to deal with all the possible contingencies. As deals become more complex, you more often need a separate entity.

Now, obviously, when you undertake a transaction, as a lawyer, one of the very first questions you ask is: Are we going to set up a separate entity or are we going to do it contractually? It is something that lawyers think about very carefully, but as I indicated, my experience has been that you do very often go with a separate entity.

If I look at the two joint ventures in which I was involved with where a separate entity was not set up, it may also be helpful to ask why was that? In one case, it actually relates to a question that was posed to the prior panel about joint ventures in the non-profit context. The joint venture involved a university and a research institute. In that context, issues relating to shielding liability, allocating profits, and other issues discussed above were not that important, and so the decision was made to deal on a contractual basis, even though the joint venture was an international joint venture.

In the other joint venture I worked on where a contractual joint venture was used, it was just the structure of the deal itself that lent itself to a contractual joint venture. In that context, our client was trying to provide services in Mexico, but at the same time was also trying to minimize taxation in Mexico. The way to accomplish this goal was through contractual licensing arrangements where an entity actually was not set up to conduct operations in Mexico. So there are reasons from a legal perspective why one tries to avoid an equity structure.

Now, since I actually spent some time sorting out what my experience in joint ventures has been, I thought I would share some additional information about those transactions. That information may not be altogether relevant to what we are talking about in this panel, but the information might be helpful or might be interesting in light of what was discussed in the prior panel and may be discussed in the next panel.

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<sup>3</sup> Sampson, *supra* note 1, at 927.

As I mentioned at the outset of my Comments, in the last six to eight years, I have been involved in twenty joint ventures. Of those twenty, five never came to fruition. That is, in a quarter of the situations, the parties were unable to ultimately reach agreement. They hired lawyers and they talked, but they did not actually set up a joint venture. What were the reasons why those five potential transactions did not come to fruition? Two of the five were in the context of acquisition transactions. Two parties were getting together to buy a business and they were never able to buy the business, and thus the joint venture never came to fruition.

In one unsuccessful situation, the joint venture was actually a research and development joint venture involving the biotech industry. The parties traveled quite a ways down the path to setting up their joint venture. All the agreements were drafted, and we had started to negotiate their terms. But things came to a stop when my client acquired a large business. All of a sudden when the client acquired that large business, the client realized that there were all sorts of intellectual property rights that were coming along in that acquisition, and those rights might impact, and might be impacted by, the joint venture that was being negotiated. So, our client decided that it was not in a position to do the joint venture. It has been about a year now since that decision was made – in fact I remember, on September 10, the day before the fateful September 11, I was supposed to fly to Germany to discuss the joint venture, and the client decided that it was going to put the deal on hold. The deal has not been revived, yet it may. But, as Jeanne Rickert pointed out in the prior panel,<sup>4</sup> things change and times change and whatever seems to be important or relevant to the joint venture at one point in time no longer may be relevant in light of other events that have occurred or are occurring.

In one of the other unsuccessful joint ventures, the joint venture did not come to fruition because of a disagreement on the governance rights of the parties to the proposed joint venture. It was to be a joint venture in Asia between a U.S. partner and an Asian partner. They could not reach agreement as to who would actually have control on different aspects of the joint venture. We were in negotiations for six months, and finally the parties realized that there was no deal to be had and to go their own ways.

The last one of my joint venture transactions that did not come to fruition dealt with intellectual property rights. A U.S. company and a Latin American company were going to combine

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<sup>4</sup> Jeanne M. Rickert, *Keep Your Eyes Open: Avoiding Unintended Consequences in Joint Venture Relationships*, 53 CASE W. RES. L. REV. 897 (2003).

their efforts from an intellectual property perspective and a marketing perspective to sell some new products in Latin America. My client, which was contributing the intellectual property, was being asked to give some guarantees, basically, flat representations that the technology being contributed did not infringe third party technology – that is representations that were not qualified by our client's knowledge. If one is a transactional lawyer, it is extremely difficult to say that one's intellectual property does not infringe anyone else's intellectual property. In order for the representation to be reasonable and within the ambit of risk that one is willing to take on, one has to limit a representation to that which is within a party's knowledge. The other party in that transaction was unfortunately represented by a trademark lawyer. With a trademark, it is much easier to make a representation that a trademark does not infringe third party rights and opposing counsel, who was a lawyer specializing on trademark matters, insisted that a flat non-infringement representation was very important with respect to matters involving patents and technology. This was especially true in the context where her client had been previously subject to troubling intellectual property lawsuits in Brazil. So, we were at loggerheads in terms of assignment of risk on intellectual property matters and negotiations terminated. It is interesting to note on the flip side, the other party that was contributing its marketing abilities to the joint venture was not willing to guarantee sales that should be achieved from its marketing abilities.

So, those are the five examples of deals that did not go forward. In each of them we were trying to create a new entity and were not traveling down the route of a contractual joint venture.

Now, of the fifteen joint venture transactions that did go forward, it is interesting to note that eight have already been unwound in one way or another. Of the seven that remain alive, I suspect a number of those will also unwind in the next few years with changing circumstances. Again, as a matter of general interest in terms of why they were unwound, I will relate the reasons for the termination of the joint ventures.

The unraveling of one of them, in fact, just closed last week. Basically both joint venture parties sold off their joint venture stakes to a third party. In two of the eight cases, including in the transaction that I referred to that closed last Friday, the unraveling of the joint venture occurred because of disputes of the parties on non-compete issues. The parties that were involved in the joint venture – or at least one of the parties – decided that it wanted to compete with the joint venture entity. That obviously raised issues

for the other party and resulted in the termination of the joint venture. In one case, both parties to the joint venture sold off their respective interests to a third party, and in the other case, one joint venture entity bought out the interest of the other party to the joint venture.

In a third of the eight cases, the joint venture unraveled because there was a change of control of a party to the joint venture. The parties had entered into a joint venture to sell color cosmetics using infomercials, and the joint venture was developing a whole new product line. Ultimately, one of the parties to the joint venture was bought out by someone else, and the new party who owned this joint venture partner decided that it did not have an interest in pursuing the joint venture and wanted it terminated. The other party was amenable to this result, and the parties simply terminated the joint venture. The parties had done a fair amount of testing and research, including test marketing these color cosmetics on television, but they ended up just terminating the joint venture and dissolving it.

In a fourth of the eight joint ventures that were terminated, the joint venture was undone because of local legal regulations in the country where the joint venture operated. In particular, the joint venture was set up in China, and the Chinese government indicated that the foreign U.S. entity could no longer participate in the venture. The foreign U.S. entity partner thus ended up having to sell its interest.

In a fifth instance of the eight joint ventures that were terminated, the market targeted by the joint venture did not develop as foreseen by the parties to the joint venture. The joint venture involved the cotton industry. For those of you who are familiar with the cotton industry, you probably know that the price of cotton has plunged in recent years, and that affected the profitability of the joint venture.

In a sixth instance of the eight joint ventures that were terminated, the parties really did not work well with each other. They of course, at the outset, thought they had a good fit together. The partners were two smaller size companies in the cryogenic industry. After a few years of working together, they simply agreed that the joint venture was not working well, and they went their separate ways.

In the last two instances of the eight situations where a joint venture was ultimately terminated, one of the entities to the joint venture ended up buying out the other party's interest in the joint venture. In each case, one of the parties entered into the joint ven-



ture because it wanted access to the market abroad served by the joint venture. In essence, a party did not have the experience or the resources to go abroad, and so it basically teamed up with another party to enter the market abroad. Over time, the party figured out that it could better run the business separately than in the context of the joint venture. Thus, it just bought out the interest of the other party to the joint venture.

So, based on this overview of some of the issues that come up in joint ventures, one key thing to keep in mind with joint ventures, which was discussed thoroughly in the last panel discussion, is that most joint ventures do unravel, usually because of the change in circumstances and the change in needs of the parties to the joint venture.<sup>5</sup> As a lawyer in private practice, one has to keep this in mind. Thus, the termination provisions, the buy-out provisions, the put-call provisions, the restrictions on transfer of joint venture interests, the non-compete provisions – all of these, even though they are contentious issues that people do not like to talk about and think about when they are getting together to create a joint venture – are key to the lawyering process with joint ventures.

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<sup>5</sup> See Symposium, *supra* note 2.