United States Market Entry for Foreign Enterprises

The Cross-border Equity Joint Venture

This blog post continues our Foreign Direct Investment series for Foreign enterprises seeking to enter the US marketplace via an acquisition of or merger with an existing US business. In this post, we discuss the cross-border equity joint venture.

Technically, joint ventures can best be described as two or more parties joining together to pursue a defined business objective for a defined term. Joint Ventures may take the form of either a contractual or equity joint venture.[1] An equity joint venture signifies the contribution of investment capital and the formation of a permanent entity. As with any capital contribution, the level of risk is heightened as invested capital can only be repatriated via profit distributions or ultimate disposition of the capital interest. Thus, in the context of an equity joint venture, the Foreign partner has committed its capital and has been allocated shares or membership interests in the JV and is "along for the ride" until certain events occur which determine its ultimate fate.

A Foreign enterprise may enter into an equity joint venture for a myriad of benefits which the U.S. Venture partner may provide such as:

- Access to the U.S. market and distribution networks
- Access to its marketing resources and customer base
- Access to capital and technology resources
- Sharing start-up costs for manufacturing
- Sharing of certain material risks
- Join forces in R&D programs

These are merely a few of the many objectives which motivates a Foreign enterprise to seek-out a JV partner.

[1] For purposes of this Post, we do not discuss the contractual joint venture, i.e., where two or more parties conduct joint business operations in accordance with a written contract or agreement and no permanent entity is organized.

On the flip side, the seminal downside and attendant risks inherent in any equity joint venture reside in the sharing with the Venture Partner the control and management of the JV business. No longer does the Foreign Partner have complete autonomy and discretion as to the direction and strategy the business deploys. For this very reason, the sure-fire way to mitigate this downside risk is the development of an intelligent and comprehensive joint venture business plan. The critical importance of this document cannot be overstated as it serves to launch and start-up the JV business and equally important, provides the roadmap for the drafting of the definitive equity joint venture agreement.

The key sections of any joint venture business plan are as follows:

Business Objective. The Plan should clearly state the business objective of the JV business and contain a clear and unambiguous mission and vision statement.

Initial Budget. The Plan should formulate a comprehensive budget covering the initial year as well financial projections over a defined term.

Choice of Entity Formation. The Plan would stipulate the form of the equity joint venture in accordance with the laws of the state in which it is incorporated. The JV may take various forms such as a Limited Liability Company or C-corporation, with each presenting different tax treatment[2].

Capital Formation and Percentage of Qwnership. These are often the most difficult terms to agree upon wherein capital contributions may take the form of cash, debt or property, or a combination thereof. Of course, the contribution of property requires agreement upon the fair

[2]. From a U.S. federal tax standpoint, ,a Limited Liability Company is a pass-through entity in which all profits and losses directly flow through to its members, whereas a C Corporation has a double taxation structure, i.e., at the Company level and at the Shareholder level.

market value of the property being contributed[3]. A third party such as an accountant may assist in the valuation exercise. With respect to the percentage of ownership, clearly the preference would be for the Foreign Partner to be accorded majority control as this would be associated with the right to manage the JV business. However, where majority control is allocated to one partner or the other, limitations upon fundamental business decisions are required for protection of the minority venture partner. These limitations are often referred to as “veto rights” which require the consent of the minority partner for any fundamental actions to be taken by the majority such as appointment of CEO, Board director appointments, issuance or sale of additional stock, termination, etc.

Corporate Governance. This section of the Plan would establish the formation of a Board of Directors, the number of directors accorded to each Party, and associated voting rights and governance procedures.

Rights and Responsibilities. The Plan should carefully define the respective roles, duties and responsibilities of each venture partner.

Tax Matters. The Plan should assess the tax implications for each JV Partner as well as the JV itself. ThIs requires careful international tax planning which addressed the relevant tax laws and regulations of each Partner’s domicile as well as the laws under which the JV is organized. Tax planning would also address the manner and terms upon which profit distributions, return of capital or liquidation proceeds are made.

[3] Note – under no circumstances, should the Foreign Partner’s capital contribution be a technology license . Capitalizing an IP license will result in the license’s recordation as an asset upon the JV’s balance sheet and as such, may be subject to the reach of creditors in any restructuring or insolvency of the JV, resulting in the Foreign Partner’s complete loss of its valuable technology. Rather, capital contributions into the JV should be paid in cash and/or debt and once capitalized, then the Foreign Partner can freely license the subject technology in a separate arms-length license agreement with the JV, thus removing the license from the potential reach of any joint venture creditor.

Executive Management. The Plan would designate the initial executive management team with the Board thereafter having the responsibility for overseeing executive management.

Intellectual Property Rights. Any license of IP needed for the joint venture's operations would be sorted and require a separate license agreement to be appended to the joint venture agreement. All other IP matters such as protection of confidential information would need to be addressed.

Transfer of Shares or Membership Interests. The Plan would outline any rights for share transfer and the specific terms and limitations upon any said transfers. In many instances, the Plan would stipulate there is no right to transfer of any JV interests to a third party. In the case where one party has majority control, the Plan may specify certain rights of transfer such as Right of First Refusal, Tag Along or Drag Along Rights[4].

Deadlock and Dispute Resolution. The Parties must plan for any deadlock at either the Board or shareholder level which may arise and its manner of resolution. In essence, an equity joint venture is akin to a "marriage" and as such, is prone to often a very contentious divorce. Obviously, It is therefore immeasurably prudent to plan ahead for any eventual divorce. Thus, deadlock may be resolved by various means such as through third party mediation or arbitration, or one party buying-out the other party's stock of membership interests, or sale of the joint venture business. Regardless of the manner of deadlock resolution, it should have a defined expiration date in resolution much be reached, and failure to do so will result in the winding-up and liquidation of the Joint Venture.

[4] "*Right of first refusal* "is a contractual right to enter into a business transaction with a person or company before anyone else can.
"Tag-along right" enables the minority partner with the right to join the sale ("tag-along") in any sale or disposition of the company. The minority investors are entitled to the same price and conditions as the majority investor when its shares are sold.
"Drag-along right" enables a majority shareholder to force a minority shareholder to join in the sale of a company.

Once the Business Plan is completed and the Partners have given the green light for the organization of the joint venture, the Plan would then serve to frame the construction, drafting and entry into force of the definitive cross-border equity joint venture agreement.