FARRER&Co

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A basic guide to the legal process

Establishing a Joint Venture

Introduction

Joint Ventures (JVs) are a useful medium for businesses wishing to pursue activities where they do not have all of the required expertise, resources or funding for the project. Whether a company is looking to diversify risk and control, combine expertise, save money, enter a foreign market or gain access to new resources, a JV with another party may provide the mechanism to achieve their goals.

A 'joint venture' is not strictly a legal term and can encompass a broad range of relationships between parties whereby they pool certain resources and share the rewards. This note is intended to outline the main principles that any party entering into a JV will need to consider. Your legal advisors will assist you in structuring and documenting the JV to ensure commercial objectives can be achieved whilst meeting the legal, regulatory and tax requirements of the venture parties.

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We use them for everything and think there is no better alternative. They understand their clients incredibly well.

- Client quote, Chambers UK, 2019

1. Why enter into a JV?

There are many reasons why a business might consider entering into a JV.

Access to resources

It might be that the company lacks the required knowledge, human capital, technology or access to a specific market to be successful in pursuing a business activity. By collaborating with another company, resources can be shared without having to invest large amounts of capital to obtain those resources.

New market penetration

It is common for a company to partner with a ‘local player’ in the new market it is looking to enter. This allows the relevant logistics to be taken care of by the local player which can significantly reduce barriers to entry and is especially attractive to parties wishing to enter markets with significant regulatory or cultural barriers.

Shared risk

Entering into a new market or creating a new product or service can be risky and a company may not wish to or indeed be able to manage the risk alone. A JV allows the parties to contribute a portion of the resources required for the project, reducing some of the financial burden placed on each side. By sharing a common pool of resources, costs of the overall project can be reduced.

Funding

Small companies will often not have the resources or capital for significant growth projects. By partnering with a larger company with access to more financial resources, the smaller company can expand at a faster rate.

Flexibility

Unlike a merger or acquisition, a JV is a temporary (although sometimes lengthy) contract between the parties which dissolves at a specific future point agreed between the parties. This may be a fixed date, when a certain milestone has been reached or simply when they agree to bring it to an end. The parties can continue running and retain control of their own operations in other areas while the JV is underway. Each party maintains its own identity and can easily carry on with its own business operations once the JV is concluded.

Common reasons for failure.

Before entering into a JV, the parties should ensure their understanding of the project, commercial expectations and culture are as aligned as possible. The most common causes of unsuccessful JVs can be grouped into the following categories:

Mismatch of objectives

The parties may have different objectives for the JV. By entering into a JV both parties inevitably forgo a certain level of control over the project and so need to ensure their respective goals are fully understood by the other.

Cultural mismatches

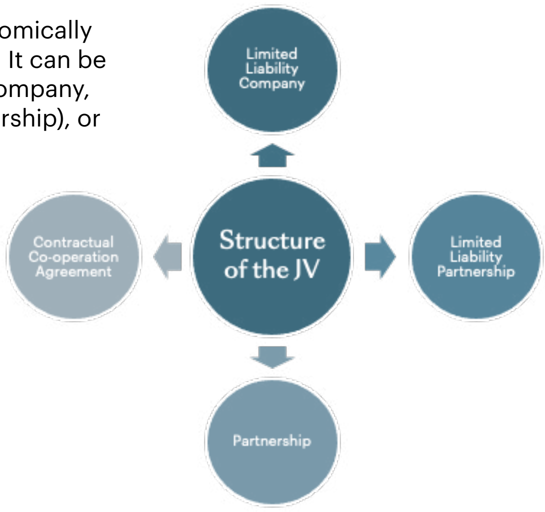
Different working methods and expectations can lead to poor integration and cooperation, which can threaten the success of the project. Parties should seek to understand and manage any cultural differences.

Imbalance in levels of expertise, investment or assets

Where one party is contributing disproportionately to the JV which is not recognised in the distribution of profits, this can lead to issues between the parties and a breakdown of the relationship.

2. How to structure your JV?

Put simply, a JV is a commercial agreement between two or more economically independent entities with a view to sharing the rewards of cooperation. It can be established via one of four basic legal structures: (a) Limited Liability Company, (b)Limited Liability Partnership (LLP), (c) a Partnership (or limited partnership), or (d) a purely Contractual Co-operation Agreement.



Broadly, the four forms reflect varying degrees of integration of the interests in the JV. The corporate structure (Ltd and LLP) will vest all of the trading activities and assets in a single, jointly owned corporate vehicle. However, a purely contractual agreement (structure (d) above) will result in no pooling of assets and no general sharing of revenues and costs. For the purposes of this note we focus on structure (a) above being a Limited Liability Company and structure (d) above being a purely contractual JV, as they are both the most commonly used and the most distinctly different.

	Advantages	Disadvantages
Limited Liability Company	• Member liability is limited to an agreed amount • Well recognised and most common vehicle used in JVs • Comprehensive legislative framework supports the contractual arrangements between the parties • Tailored share rights to reflect size, contributions and motivations of the JV • As a separate legal entity the company can enter into contracts, sue and be sued, borrow money, and hold property in its own name • It is possible to create a governance structure within the vehicle which satisfies the purpose of the JV e.g. voting rights for different members, exit triggers, and accession of new members.	• Companies are subject to statutory regulation which can be onerous for directors • The company must be publicly registered at Companies House and as an incorporated company it will need to file accounts and other information on a regular basis • Directors can be subject to personal liability if they breach duties • Deadlock can occur where the parties cannot agree which may lead to complex exit procedures being triggered • Companies are not tax transparent
Purely Contractual Arrangement	• Flexibility is a key advantage with the parties able to quickly set up the JV or dismantle it as no separate entity is formed. This is useful for short term or single-goal JVs • Parties retain ownership of their assets • Parties not liable for the debts of the other but may share liability on specific contracts with third parties • Each party taxed directly on its share of profits and losses of the venture	• No separate legal entity which can enter into contracts, sue or be sued, borrow money, or hold property in its own name. This can create an unclear structure and make internal operations complicated • There is a risk of a partnership being formed which would result in unlimited joint and several liability where each JV party is liable for all losses of the venture • May be difficult to raise external debt finance as there is no separate legal entity owning its own assets.

3. What laws govern JVs?

There is no UK legislation which specifically governs JVs. If a JV is established by way of a UK incorporated company then UK company law will apply e.g. the Companies Act 2006.

A limited liability partnership will be created under and governed by the Limited Liability Partnerships Act 2000.

A contractual JV will be governed purely by contract law.

4. Key Documents

Setting up a JV will require the following key documents to be agreed.

Non-Disclosure Agreement (NDA)

An NDA should always be entered into early in any negotiation process. It is likely throughout the negotiation process the JV partners will need to share sensitive and confidential information relating to their businesses. A properly drafted NDA ensures the recipient cannot misuse that information and although the exact terms of the NDA may be negotiated, experienced parties will always expect to enter into one in some form or other.

Heads of Terms

Before the detailed JV documents are drafted, the parties will usually agree a basic framework for the deal in a Heads of Terms document (often referred to simply as the **Heads**). Although this document may only run to two or three pages and is usually expressed to be non-binding on the parties, the Heads ensure that there is agreement in principle on all key terms of the JV before significant time and money are invested in the full process. Whilst it may be tempting not to involve lawyers and accountants at this preliminary stage, the Heads are an important document and should have professional input before being signed. Tax advice at this early stage will also be important, particularly if the parties are subject to different tax regimes.

JVA/Shareholders' Agreement

The JVA is the principal transaction document which will be entered into by the parties and will establish and govern the JV. It includes all the terms in detail and the operative parts are likely to be the subject of most of the negotiation time. The JVA will also include certain boiler plate provisions that are not usually negotiated heavily, but which are designed to provide certainty on a variety of legal matters (such as confirming the governing law applicable to the contract). We look in more detail at some of the principal terms of the JVA below.

Articles

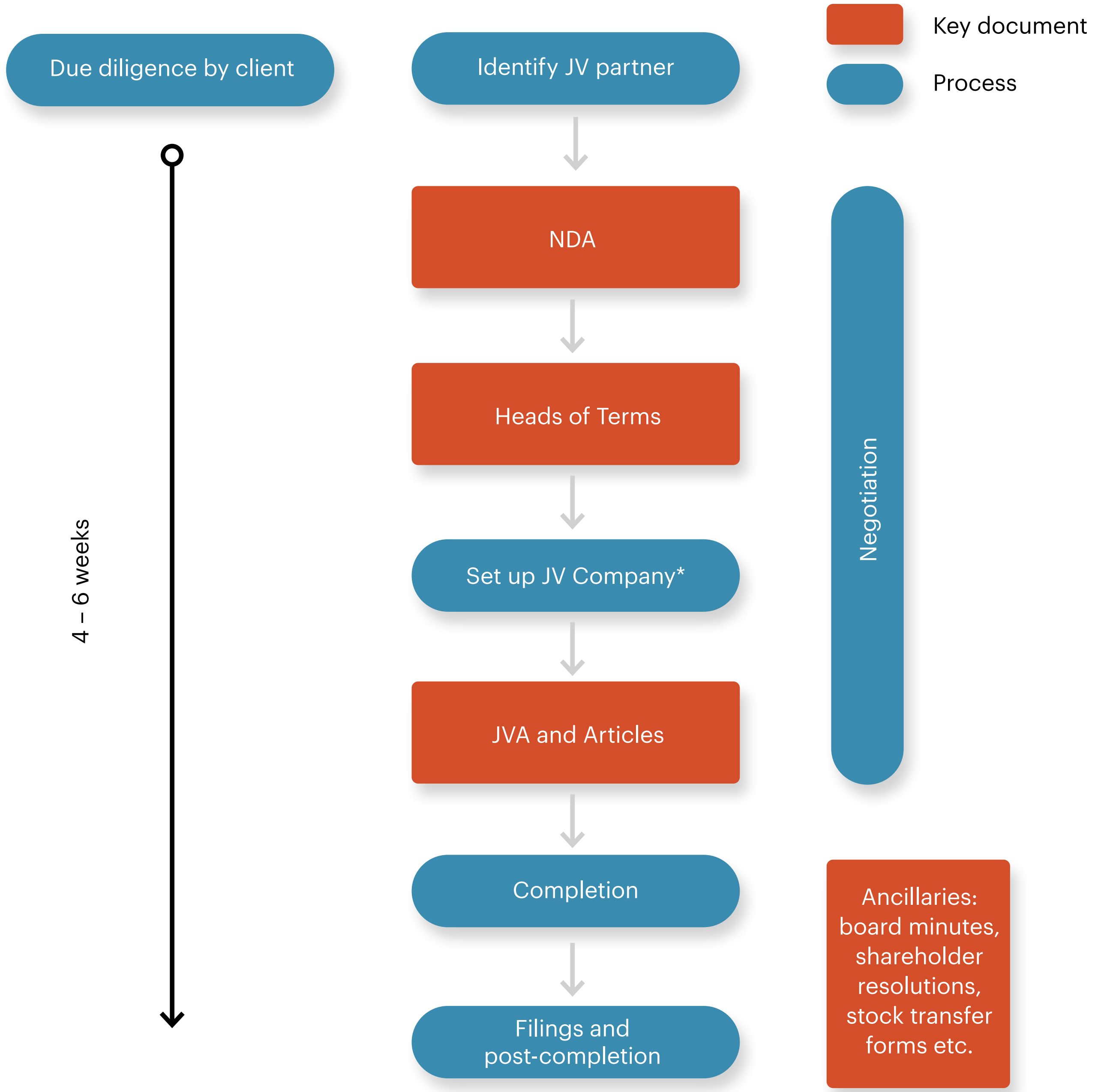
Where the JV is established by way of a JV Company, the JV will also be governed by the Articles which are publicly registered at Companies House. It is customary for the Articles to include provisions relating to board appointment rights, powers and responsibility and decision making of the directors, share transfer restrictions, pre-emption rights, permitted transfers, further issuance of shares and dividend policy. The JVA and Articles will work together as the governing documents of the JV. Where no JV Company is incorporated, the provisions commonly found in the Articles will be incorporated into the JVA.

Ancillaries

In addition to these key documents listed above there will likely be a suite of ancillaries required, particularly where the parties choose to incorporate the JV through a JV Company. This includes board minutes, shareholder resolutions, stock transfer forms, Companies House filings and client communications, all of which are important to the transaction but which are not usually the subject of significant negotiation.

5. Timeline

A JV can be established quickly if the parties are agreed on the commercial terms. Where both parties are committed to a deal (and with a fully engaged team of supporting professionals) the JV process will typically take from four to six weeks from signature of an NDA to formal execution of the JVA (**Completion**). The timeline can become protracted where the parties are not commercially aligned and where significant negotiation is required on any issues.



*This step is only required if the parties choose to establish the JV through a JV Company.

6. JVA concerns for parties

As we have already seen, the JVA (and the Articles) contain the full details of the JV structure, the obligations of the parties and the provisions governing how the JV will operate. It will flesh out all of the matters which were agreed in principle in the Heads.

Although no elements of the JVA are superfluous, many can be left to negotiation between lawyers. Depending on the complexity of the JV, some terms will, however, be of particular concern to the parties who will work closely with their lawyers to ensure they properly reflect what has been agreed with the other JV Party. These include:

Identity of the JV parties

How the parties choose to enter into the JV (for example, as an individual, via a partnership, company or other body) is often driven by tax implications and this is something your lawyers and accountants will be able to advise you on.

Business of the JV

It is important that the business of the JV is clearly defined. For example, the parties will need to identify whether there is a specific project being undertaken by the JV or whether this will be a continuing business, where the business will be based, the parties' objectives etc.

Financing the JV

The parties will need to decide how much each party will contribute to the JV Company. It may be that the JV will be financed equally by the parties. However, it is sometimes the case that one party will provide financing whilst the other provides expertise. It is also possible that one party might provide the initial funding and the other party will have an option, or sometimes an obligation, to provide further funding further down the line. There may also be third party investors or debt providers helping to finance the venture. Financing is often driven by tax implications and this is something your lawyers and accountants will be able to advise you on.

Board of directors

Depending on how the JV is structured, each party will likely want the right to appoint directors to the board of the JV Company. Aspects such as structure and control of the board, powers of the directors, voting arrangements, appointment of a chairperson etc. will all need to be agreed by the parties.

Ownership of the JV Company

The day to day operations of the company will be handled by the directors of the company. Depending on the structure of the JV, a party may require that their consent is required in order to take certain important decisions such as amending the business plan of the JV Company, amending the Articles, issuing and allotting new shares etc. It is customary for these matters to be referred to as 'Reserved Matters' and to be included in a schedule to the JVA together with the mechanism by which consent is to be provided.

Deadlock

Deadlock occurs when there is an equal number of votes for a particular decision. This can particularly be an issue where the JV is established on a 50:50 basis. The process to be followed where a deadlock is reached will be set out in the JVA or the Articles and may include a chairman having a casting vote, independent non-executive directors being brought in, an external arbitrator being involved, or the parties agreeing that in deadlock one party will have the right to exit the JV by selling their shares to the other JV Party. How the parties want to deal with this occurrence is a commercial decision.

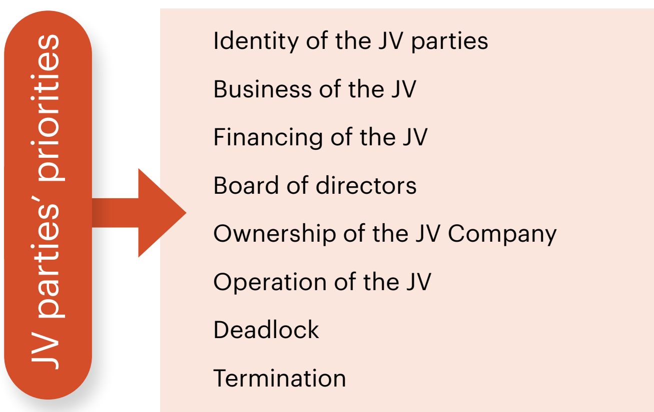
Termination

A common concern for JV parties is how and when they will terminate the JV. The parties can specify circumstances which would result in a termination, for example: (i) a certain milestone being reached or a project concluding, (ii) insolvency of one of the parties, (iii) transfer of shares by a party, (iv) a change of control by one of the JV parties, (v) a material breach of the JVA or (vi) a notice of termination given after a specified period.

New Investors

It is sometimes the case that the parties want to bring in a new partner into the JV. The JVA will normally include a mechanism for acceding the new partner into the JVA so that they are required to comply with the obligations thereunder. The new partner will also become a shareholder of the JV Company and will therefore automatically be subject to the Articles.

Main JVA terms



7. Completion and post-completion

Once all of the terms of the JVA and Articles have been agreed and the JV Company incorporated (where relevant), lawyers for the JV parties will then coordinate to ensure all signed documents and other deliverables (company books, ancillary board meetings and resolutions etc.) required to establish the JV are in place. At this point the documents can be executed and the JV established. Although there can occasionally be last-minute delays, Completion is usually a relative formality because everything has been lined up prior to Completion.

The final steps in a corporate JV establishment are usually:

1. Issuing shares in the JV Company to the parties
2. The Company issuing the parties with share certificates in respect of their shares
3. The statutory register being updated with the names of the parties
4. Filing of various Companies House forms to reflect the new ownership and control of the JV Company.

8. Conclusions

This note is only a summary of the key steps in establishing a Joint Venture. Setting up a JV can be relatively straightforward but there are many potential pitfalls which you will need to be aware of as you progress through the process.

Legal, tax and accounting input should all be sought at an early stage and will ensure that both parties are properly protected.

Farrer & Co's Corporate team are specialists in establishing Joint Ventures and have acted regularly for companies, institutions and individuals in the formation, funding and completion of JVs. We would welcome the opportunity to discuss any aspect of this briefing note with you.

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10. Glossary

Ancillaries	an umbrella term for supporting documentation such as board minutes, shareholder resolutions, Stock Transfer Forms and Companies House filings that are required to effect a transaction
Articles	articles of association which forms part of the constitutional documents of a company
Boiler plate	a general term for the suite of clauses in the SPA or BPA dealing with legal matters that are not usually core to the transaction
Completion	the point at which the deal is legally concluded and ownership of the Target transfers to the Buyer
Deliverables	a general term for documents and physical items to be delivered by either party at Completion
Disclosure	the formal process by which a Buyer is fixed with knowledge of matters that are inconsistent with the warranties
Heads (of Terms)	a (largely non-binding) document setting out the key terms of the proposed transaction
JV	Joint Venture
JV Company	if the parties opt to establish the JV by way of a company, this is the vehicle by which the parties will operate the JV
Joint Venture Agreement/JVA	the principal transaction document where the parties agree to enter into a JV and set out the terms that will govern such JV
Parties	the entities, institutions or individuals entering into the JV

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Excellent market knowledge, very commercial, pragmatic and practical advice.

- Corporate M&A, Legal 500 2020

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