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How To Choose The Right Form Of Joint Venture

Law360, New York (February 04, 2014, 3:04 PM ET) -- There are a number of forms that a joint venture may take, which allows the parties significant flexibility in designing an arrangement most appropriate for their proposed venture. To determine the best form for a joint venture, a number of factors must be considered.

Tax Efficiency

One of the most important factors to consider when choosing the form of a joint venture is the tax efficiency of each structure:

- ***Contractual Joint Ventures.*** There are no particular tax effects or advantages unique to or common among contractual joint ventures. The potential profits or losses and the tax effects to each participant in a contractual joint venture must be examined on a case-by-case basis. As a result, there are no general tax assumptions that can be made about contractual joint ventures.

- ***Corporations or LLCs Electing Corporation Treatment.*** Corporate joint ventures and limited liability joint ventures (unless the parties make an appropriate tax election to the contrary) have the advantage of being responsible for their own tax obligations. To the extent that the corporation generates profits and has a positive cash flow sufficient to pay its taxes, a corporate, or limited liability company joint venture, as applicable, may be advantageous.

- ***Partnerships or LLCs Electing Partnership Treatment.*** On the other hand, if a joint venture is expected to generate losses for an extended period of time, the parties may elect a partnership joint venture or a limited liability company joint venture (where the parties choose tax treatment as a partnership) in which the losses will flow through each of the income statements of the co-venturers and have the effect of offsetting and reducing the taxable income and taxes of each of the joint venture parties. Otherwise, such losses will continue to build up in the corporation and be of no use or limited use under applicable tax laws if the joint venture becomes profitable in the future. In addition, partnership joint ventures and limited liability joint ventures that elect partnership treatment have significant flexibility in allocating losses and profits among partners or members, and may also have greater flexibility to address certain tax planning needs of their partners or members.

Limiting Liability

Another primary factor in choosing a structure is limiting the liability of the participants:

- ***Contractual Joint Ventures.*** There are no particular liability attributes of contractual joint ventures, and each contractual joint venture must be examined on a case-by-case basis to analyze and address exposure for liability among the joint venture parties. However, contractual joint ventures provide parties with maximum flexibility to address and allocate potential liabilities relative to all other types of joint ventures. If such flexibility is of paramount importance, then this form of joint venture should seriously be considered.

- ***Partnerships.*** General partnership joint ventures create the greatest exposure to joint venture partners for individual liability for the acts of the joint venture since the liability of the partners is not limited to their investment in the joint venture and is also joint and several. A limited partnership may serve to limit the liability of its limited partners, but its general partner will remain fully liable for the acts of the limited partnership. If limiting the liability of co-venturers for the acts of the joint venture is a critical issue for the parties, then a partnership joint venture should be avoided.

- ***Corporations.*** Both corporations and limited liability companies provide maximum flexibility in limiting the liability of the joint venture parties for the acts of the joint venture to the amount of the investment of each party in the joint venture. However, joint venture partners in corporations are limited in their ability to allocate and limit liability among themselves, especially with respect to liabilities for violations of fiduciary duties. To the extent there is a co-venturer who will be an officer, director or majority owner in a joint venture but who desires maximum flexibility to act in its self-interest without regard to its fiduciary duties, then it should avoid a corporate joint venture and advocate for a limited liability joint venture instead.

- ***LLCs.*** LLC joint ventures formed under Delaware and certain other state laws permit joint venture partners not only to limit their liability for the acts of the joint venture but also to limit their liability for fiduciary duty violations when acting in their self-interests, even when such actions conflict with the best interests of the limited liability company. There may be exceptions to the ability to limit liability, however, and the laws of the relevant state of organization must be checked to determine such limits.

Time and Expense

In general, the complexity of the joint venture, rather than its form, will have the biggest impact on the time and expense required to properly establish the enterprise. Even though a separate entity is never established, some contractual joint ventures may be just as complex as a partnership, LLC and/or corporate joint venture due to the inherent nature of the joint undertaking.

For example, strategic alliances often involve shared liability, shared intellectual property, the exchange of confidential information, shared financial and nonfinancial investments, dispute resolution and exit provisions that can be just as complex, if not more complex, than joint ventures involving the establishment of separate entities.

Additionally, LLCs, corporations and partnerships have certain accounting and monitoring expenses that a contractual joint venture would not, but there may be similar costs involved in auditing and monitoring strategic alliances and contractual arrangements.

For example, as part of a complex acquisition involving Lenovo and the personal computing business of IBM, Lenovo and IBM entered into a global strategic alliance in which Lenovo is the preferred provider of IBM branded personal computers while IBM provides financing and maintenance services for purchasers of such computers.

That alliance has led to discussions regarding additional transactions, and an exit from this complex alliance by either party would not be a simple matter. Therefore, although separate entity joint ventures do have formation requirements and costs that contractual joint ventures do not, the time and expense involved in the creation of these entities rarely plays a deciding factor in choosing the form of the joint venture.

When determining how much time and expense may be involved for a particular joint venture, the biggest factor that the parties must consider is the number and magnitude of existing contractual obligations that may be triggered:

- ***Notice and Third-Party Consent Requirements*****.** The establishment of a separate entity joint venture and the transfer of assets or the cash investment in a newly formed entity may trigger notice or third-party approval requirements to lenders, stockholders or other parties under existing contracts of a co-venturer. Obtaining these approvals may take additional time and effort apart from the negotiation of the joint venture arrangements.

- ***Existing Noncompete Arrangements.*** Joint ventures that require the establishment of a jointly owned entity that will enter new markets may also trigger existing noncompetition agreements that must be addressed.

- ***Existing Confidentiality Obligations.*** Joint ventures that require the disclosure to third parties of confidential information may trigger existing confidentiality agreements that must be addressed.

Implications for Existing Operations and Reporting Requirements

The co-venturers must ensure that their joint venture will not interfere to an unreasonable degree with the operation of their existing businesses.

- ***Contractual Joint Ventures.*** Contractual joint ventures are likely to have the least impact on existing operations and reporting requirements. Strategic alliance, joint development or marketing arrangements, as well as licensing and distribution arrangements are likely to be extensions of the existing operations of the parties. Such arrangements are designed to require the least amount of change to the manner in which the parties currently operate. Although contractual joint ventures may involve noncompete and exclusivity arrangements that may impact existing operations, such arrangements are typically narrower in scope than those under other types of joint ventures. However, contractual joint ventures may nevertheless be material to one or more of the parties and may trigger SEC disclosure obligations under the 8-K rules as well as any other disclosure obligations under the 10-K rules or the rules and regulations relating to registration statements with respect to material contracts. There may also be approval, notice or disclosure obligations to lenders or other business partners with respect to the entry into material contracts or contracts involving capital or other obligations exceeding certain limits.

- ***Partnerships and Corporations.*** Corporation and partnership joint ventures, especially those requiring significant cash investments or asset transfers, may have a significant impact on existing operations of co-venturers. They may take resources away from existing operations and significantly alter the operations of certain divisions or in certain markets. They may also require the hiring of additional management personnel or may require that existing personnel serve in dual capacities in the operations of the new venture, as well as in a co-venturer's existing operations. The noncompete and exclusivity obligations that are common in corporate and partnership joint ventures may curtail existing operations in ways that would not have otherwise existed. To the extent that a corporate or partnership joint venture is majority owned by one of the co-venturers, accounting rules will require the consolidation of the joint venture's operations into the financial reporting for the majority owner. As a result, U.S. Securities and Exchange Commission disclosure obligations with respect to financial reporting and with respect to principal subsidiaries will be triggered, especially if the operations of the joint venture are significant relative to the operations of the majority owner. To the extent that a co-venturer enters into any material agreements, such as noncompete or other agreements, in connection with a corporate joint venture, all of the disclosure issues discussed above with respect to material agreements will also apply.

- ***LLCs.*** All of the operational and reporting raised with respect to partnership and corporate joint ventures will also apply to LLCs. In addition, the LLC agreement itself may be deemed a material contract, triggering disclosure obligations noted above with respect to the entry into material contracts. For limited liability company joint ventures that elect to be treated as a partnership for tax purposes, there will be ongoing financial reporting obligations with respect to the joint venture to reflect its portion of the earnings and profits in the financial reports of the co-venture regardless of their percentage ownership in the joint venture.

Ownership and Control Issues

Another important consideration in choosing the form of joint venture is the ownership and control of the joint venture and its assets.

- ***Contractual Joint Venture.*** Contractual joint ventures offer maximum flexibility in designing ownership and control of the joint venture, as there are no corporate formalities that must be followed. In contractual joint ventures, the parties typically retain all ownership and control of the assets that they contribute to the venture. To the extent that the collaboration will create new products or services, the parties can contractually agree on the allocation of ownership without the need to account for their relative contribution of capital or assets to the joint venture.

- ***Corporations, Partnerships and LLCs.*** In general, in corporate, LLC or partnership joint ventures, the parties' share of assets, profits, liabilities, and management and voting rights are tied to their percentage ownership interests in the joint venture. Typically, the joint venture agreement provides for control by a majority owner or group of owners, with certain protections built in for the minority investors. In some instances, however, there may be two equal joint venture partners. Although separate entity joint ventures do permit some flexibility in the allocation of control and ownership of the assets, profits and liabilities of the venture, the creation of such flexibility requires provisions that are far more complex than those generally required in contractual joint ventures. For example, as mentioned above, these types of joint ventures usually provide for veto or approval rights for minority investors. They also permit the issuance of multiple classes of equity to establish or grant voting or management rights to minority owners that are not tied completely to their financial investment. Separate entity joint ventures may also provide minority holders with rights to proceeds from the liquidation of certain assets or special rights to approve the sale or acquisition of certain assets, and they may also include specific allocations of obligations for certain liabilities in the stockholder, partnership or LLC agreement of the joint venture.

Antitrust Concerns

Regardless of the type of joint venture established, the parties to any collaboration between competitors must be sure to carefully consider potential antitrust issues that may arise.

HSR Filing Requirement. Under the current rules of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (15 U.S.C. §§ 15c-15h (1976)), parties are required to file notification with the Federal Trade Commission and the U.S. Department of Justice when a proposed transaction (such as a merger, joint venture, stock or asset acquisition, or exclusive license) meets specified thresholds and no exemptions otherwise apply.

If notification is required, the transaction cannot close while the statutory waiting period runs and the agencies review the transaction. Although the waiting period is 30 days, regulators may request additional time to conduct their review.

Exemptions. There are a range of transactions that are exempted from filing (see 16 CFR 802), including:

- intraparty transactions;
- acquisitions of goods in the ordinary course of business;
- acquisitions by newly formed joint ventures without a controlling person and holding less than $10 million in assets;
- reorganizations and workouts;
- passive investment transactions of less than 10 percent of a target's securities; and
- certain transactions that must be approved by other agencies.

Informal Inquiries. In addition, if parties have questions as to whether a review is required, informal inquiries can be made to a staff member at the Premerger Notification Office. However, any analysis conducted by a staff member will not be binding on the office.

Parties may confirm any advice received from a staff member by sending a letter to the office stating, among other things: (1) the date of contact, (2) the facts presented and (3) the conclusions reached. Such letters are subject to the Freedom of Information Act, but confidential information may be redacted upon request.

Size-of-Person and Size-of-Transaction Thresholds. Most commonly, a filing is required if the parties meet both the "size-of-person" and "size-of-transaction" thresholds.

- *Size-of-person.* The size-of-person test is met if one party to the transaction has $141.8 million or more in annual sales or total assets and the other has $14.2 million or more in annual sales or total assets.

- *Size-of-transaction.* The size-of-transaction test is met if, as a result of the transaction, the buyer will acquire or hold voting securities or assets of the seller, valued in excess of $70.9 million

Raising Prices or Restricting Output. In addition, any collaboration among competitors, regardless of the size-of-transaction or size-of-person thresholds under the HSR Act, may be deemed illegal under the antitrust laws if the collaboration raises prices or restricts output.

Even legitimate collaborations among competitors can be examined for their reasonableness and overall competitive effects. However, these antitrust regulations are subject to interpretation.

Section 7 of the Clayton Act prohibits any transaction that may lessen competition substantially. This can include price fixing, bid rigging, invitations to collude, price signaling, allocations of supply or markets, and restrictions on supply. These are broad concepts that have broad applications to all kinds of joint endeavors among competitors. Accordingly, all joint arrangements require antitrust analysis, especially among market leaders.

Foreign Antitrust Filings. It should be noted that antitrust filings and review may be required in foreign jurisdictions to the extent of the operations of the joint venture or the joint venture parties in foreign jurisdictions and the effects of the joint collaboration on foreign markets.

The antitrust laws in non-U.S. jurisdictions are continuing to develop, and many are just as complex as those in the U.S. The applicability of these laws to the joint venture must also be determined, and their applicability to collaborations between competitors may similarly apply to all types of joint ventures.

Industry-Related Regulatory Issues

If the parties intend to operate in a highly regulated industry, such as banking and financial services, health care, airlines or telecommunications, they must also consider the regulatory implications of their proposed joint venture. Each industry has its own rules and regulations that apply to joint ventures, alliances and strategic collaborations.

To help ensure that their joint venture will be approved by the relevant regulators, the parties should determine at the outset whether there are any forms of joint venture that have already been examined or approved and should consider organizing themselves in a similar fashion.

International Concerns

If the joint venture intends to operate internationally, regardless of the form of their endeavor, it is critical that the parties understand and determine how various international laws will affect the venture, such as:

- Export regulations set forth under regulations promulgated by the U.S. Department of State, U.S. Department of Commerce, U.S. Department of Energy, the U.S. Defense Department and the U.S. Treasury Department, among others;

- Economic sanctions set forth under regulations promulgated by the U.S. Office of Foreign Assets Control in the Department of Treasury ;

- Embargo regulations set forth under regulations promulgated by the OFAC;

- Foreign Corrupt Practices Act (78 USCS §78a) requirements; and

- Customs and anti-boycott regulations set forth under regulations promulgated by the U.S. Customs and Border Protection, the Bureau of Industry and Security, the Department of Commerce, and the OFAC.

Some of these regulations will apply to corporate joint ventures, and others will apply to separate entity joint ventures, regardless of specific provisions in the joint venture agreement. It is important to review and understand any potentially applicable regulations at the earliest stages of developing a joint venture.

Exit Strategies

Finally, of course, the parties must consider the exit strategies available to them with each form of joint venture:

- ***Contractual Joint Ventures.*** Contractual joint ventures typically provide for the easiest exit with minimal tax consequences. If, however, they are highly complex long-term arrangements that involve the joint development of new products, technology or services, then exiting the venture may prove more complicated.

- ***Corporations.*** If the joint venture parties expect to exit in a public offering or through the sale of the joint venture to one or more third parties, then a joint venture in the form of a corporation may be the best form, as common stock in a corporation is the most liquid and underwritten type of equity in the public market.

- ***LLCs.*** If the parties expect to exit through a liquidation, then a joint venture in the form of an LLC may be best due to the flexibility it offers with respect to the timing and terms of a liquidation. Under many state partnership and limited partnership laws, a partnership is liquidated whenever one partner withdraws from the partnership unless otherwise stated in the partnership agreement. In those states, there is no automatic dissolution upon the departure of a member under the applicable limited liability company act. However, in either partnerships or LLCs, the joint venture agreement may specify the events upon which dissolution may occur. In neither case may a party be forced to remain in the venture; however, a departure not permitted under the terms specified in the agreement will lead to damages for breach of contract.

- ***General Partnerships.*** General partnerships may create the most difficulties with respect to exits due to the (1) unlimited, joint and several liability of the partners and (2) automatic liquidation mechanisms triggered upon withdrawal of one of the partners in many jurisdictions, including Delaware.

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