ashurst

Joint Ventures in England and Wales

International Investor Series No. 6

Australia Belgium China France Germany Hong Kong SAR Indonesia (Associated Office)
Italy Japan Papua New Guinea Saudi Arabia Singapore Spain Sweden
United Arab Emirates United Kingdom United States of America

Joint Ventures in England and Wales

International Investor Series No. 6

Contents

1.	Introduction	1
2.	Nature of the business	2
3.	Investigation	3
4.	Agreeing the basis of the transaction	5
5.	Structuring the joint venture	6
6.	Financing the joint venture	8
7.	Contribution of assets to the joint venture	9
8.	Managing the joint venture	10
9.	Dealing with deadlocks	11
10.	Minority protection	12
11.	Transfer of shares	13
12.	Exit strategies	14
13.	Principal documents	15
14.	Conditions	17
15.	Restrictive covenants and protection of goodwill	18
16.	Conclusion	19

Appendices

Appendix 1	About this briefing	21

This publication is not intended to be a comprehensive review of all developments in the law and practice, or to cover all aspects of those referred to. Readers should take legal advice before applying the information contained in this publication to specific issues or transactions. For more information please contact us at Ashurst LLP, Broadwalk House, 5 Appold Street, London EC2A 2HA T: +44 (0)20 7638 1111 F: +44 (0)20 7638 1112 www.ashurst.com

Ashurst LLP and its affiliates operate under the name Ashurst. Ashurst LLP is a limited liability partnership registered in England and Wales under number OC330252. It is a law firm authorised and regulated by the Solicitors Regulation Authority of England and Wales under number 468653. The term "partner" is used to refer to a member of Ashurst LLP or to an employee or consultant with equivalent standing and qualifications or to an individual with equivalent status in one of Ashurst LLP's affiliates. Further details about Ashurst can be found at www.ashurst.com.

© Ashurst LLP 2014 Ref: 9004017 January 2014

1. Introduction

As an international investor who wishes to enter into a joint venture in England and Wales (either with a joint venture partner based in England and Wales or in another jurisdiction), you need to understand the process by which such a joint venture can be brought to fruition, principal potential areas of concern and the main documents that will be involved.

The first steps in preparing to enter into a joint venture arrangement should include formulating of a well researched business plan, carrying out a full investigation into the proposed joint venture party, and agreeing in principle the main terms of the collaboration. The new business will then need to be placed within the most appropriate legal framework to achieve the commercial aims of the parties.

A joint venture will often involve the creation of a new entity (usually a private limited liability company) through which the business of the joint venture will be carried out. However, another form of collaboration between the joint venture partners may better suit the parties' needs. For example, a direct contractual relationship between the parties or the 100 per cent acquisition by one party of the other may be the most appropriate way of enabling the parties to achieve their objectives.

2. Nature of the business

To have a clear idea of the nature of the business which the joint venture will carry out, it is essential to carry out sufficient research into:

- the market into which you intend to enter;
- the joint venture's potential competitors;
- the financial backing required;
- the regulatory framework within which business will need to operate;
- the geographical scope of the joint venture;
- the parties' long-term goals (e.g. flotation, sale to investor or trade buyer).

Once the nature of the business has been ascertained, the process of establishing the joint venture can get underway.

3. Investigation

Before you invest substantial cash or assets into the proposed joint venture, you will need to appraise the other parties to the transaction. This due diligence investigation should cover your proposed joint venture partners, their owners and the arrangements each partner has with its financial backers. If the proposed transaction involves investment in an existing company which is already trading, you should also investigate the affairs of that company. Of course, unless your financial strength is manifest your new business partners will also wish to carry out due diligence on you.

Clearly, the amount of investigation required varies from transaction to transaction but it is prudent to consider the following matters.

Legal audit

The legal audit may comprise a detailed examination of the structure of the proposed target, a report on the sufficiency of the commercial and financial contractual arrangements entered into by the target, and/or an investigation of the legal affairs of any joint venture counter-parties.

A joint venture transaction will often incorporate elements which are similar to a share or business acquisition: the target joint venture company may be an existing company owned by one of the parties or, one or more parties may be proposing to contribute assets to the joint venture vehicle. For example, a party may wish its solicitors to investigate:

- the scope of the other party's intellectual property rights which are to be used by the joint venture; or

- the regulatory framework within which the joint venture will have to operate.

Also, in relation to pensions, an investor will need to investigate all present or historic participation in pension schemes by the target company and any joint venture counter-party. Defined benefit schemes (**"DB Schemes"**) (also known as final salary schemes) will require the most rigorous levels of investigation because an investor may be exposed to substantial liabilities, for example a statutory payment if a relevant DB Scheme is in deficit or the extensive powers of the UK Pensions Regulator. These pensions liabilities may exceed the value of the deal itself.

Accountants' investigation

An investor may also instruct a firm of accountants to prepare a financial due diligence report following on the proposed joint venture. The matters covered by this report will vary depending on the nature of the transaction but may include:

- a description of the history, current assets and trading position of the joint venture partner;

- details of the corporate structure of the joint venture partner, including directors and employees;

- a review of the financial aspects of the joint venture partner's group, including analysis of the accounts;

- a review of the consequences of investing in the joint venture on the investor's liability to tax;
- a recommendation as to the preferred structure of the joint venture.

There may be an overlap between the legal audit and the accountant's investigation but careful drafting of the initial instructions can avoid duplication of cost and effort.

Other due diligence

Apart from investigation by solicitors and accountants, you may wish to appoint a financial adviser to advise on the terms of the deal. Their role may include assisting with the negotiation and financial aspects of the deal. Instead, or in addition, the appointment of other specialist advisers, such as property or environmental consultants may be also appropriate.

Confidentiality

As much of the information sought through the due diligence process will be commercially sensitive, the parties may not be prepared to make it available to each other without confidentiality undertakings being given. There may be some market or other information which the other parties are not prepared to make available at all.

4. Agreeing the basis of the transaction

Either before due diligence starts or at the end of this process, the parties may sign heads of agreement (or "heads of terms") to record the principal terms of the transaction. It is very important that the heads of agreement are stated to be "subject to contract". If these words do not appear, there is a danger that the document will create a binding legal contract even though the full details of the joint venture arrangement have not been determined.

5. Structuring the joint venture

The structuring of any transaction will be driven by the commercial objectives of the parties but will often be heavily influenced by tax considerations. It is, therefore, important to agree the structure of the transaction at a very early stage.

Although the most common structure for a joint venture often involves setting up a private limited company, sometimes a form of a direct contractual relationship between the parties may better suit the parties' needs. Examples of the types of contractual arrangement which might be used include:

- a collaboration agreement for joint marketing, joint research or the development and manufacture of goods to a particular design;
- an agreement for continuing supplies of goods or services;
- a licensing or franchising agreement;
- a distribution or agency agreement;
- a landlord relationship (e.g. a lease with turnover rent).

If a new vehicle is to be created, consideration will need to be given to the type of legal entity which best meets the parties' needs. The arrangement could use any one of the following structures:

- a limited liability company;
- a partnership organised under the Partnership Act 1890 (a "general partnership");
- a limited partnership organised under the Limited Partnerships Act 1907 (a "limited partnership");
- a limited liability partnership organised under the Limited Liability Partnerships Act 2000 (an "LLP");
- a European Economic Interest Grouping ("EEIG");
- an unlimited company; or
- an overseas entity.

A limited liability company affords its members the benefit of limited liability and provides a familiar and flexible vehicle for business which can raise finance and hold assets in its own name. However, it is often not the most tax efficient vehicle for a commercial joint venture.

Each of the three types of partnership can have tax advantages for both the joint venture and the participants, but each structure has features which need to be considered. These are set out below.

A general partnership is the most common form of partnership (firms of solicitors and accountants are often formed as general partnerships) but the liability of the partners is completely unlimited.

A limited partnership does provide limited liability for the majority of its investors but care needs to be taken to ensure that these investors retain sufficient control of the joint venture without losing their limited liability. This is because a limited partnership must have at least one "general" partner who manages the partnership but who does not have the benefit of limited liability (although this general partner can be a limited company). The limited partners may not take part in the management of the partnership without incurring the same liability as the general partners.

Nevertheless, if properly structured, this type of entity can provide a flexible and tax efficient joint venture vehicle. In particular, limited partnerships are often used as vehicles for investment in property and for raising funds for equity investment in unquoted companies ("private equity funds").

In contrast to the majority of the other types of partnership, an LLP has a separate legal personality and can enter into legal obligations in its own right. However, an LLP also suffers the administrative burden and cost of complying with the provisions of the Companies Act 2006. This means that, among other things, the LLP has to publicly file certain information about itself and its financial position which can be kept confidential in the case of a general partnership or limited partnership.

An LLP does afford all of its members limited liability but care must be taken in structuring business arrangements so that the LLP’s dealings with third parties are not seen as having been conducted by a member on its own account, thereby losing the benefit of limited liability. The combination of tax transparency (except in the case of pension fund investors), separate legal personality, and limited liability may be very attractive to many investors who wish to enter into joint ventures.

An EEIG is a form of association established under European law and is recognised throughout the European single market. However, EEIGs may not be formed with the object of making a profit and they do not afford their members the same degree of limitation of liability as a limited company. They are therefore not suitable for commercial joint ventures.

Unlimited companies are rarely used as they do not afford their members limited liability and are unlikely to be appropriate for standalone commercial joint ventures. However, when this structure is used in conjunction with limited liability vehicles, it may assist with tax transparency, particularly, for example, with US investors.

In some cases, for tax and commercial reasons, it may be appropriate to use an overseas entity to carry on the joint venture business, even though enterprise is to be carried on in England and Wales.

Tax

A joint venture which is structured as a partnership will generally have the advantage that it will be "transparent" for tax purposes (although, importantly, if a pension fund or life assurance company invests in an LLP which is used for investment or property investment it will not benefit from this transparency). This means that profit and losses generated by the joint venture will be treated as profits and losses of the joint venture partners and will not be subject to an extra layer of taxation at the joint venture entity level. A further advantage of a partnership is that the contribution of non-cash assets to the joint venture by the partners (in contrast to the transfer of assets to a company for shares) will often not attract stamp duty.

6. Financing the joint venture

You should already know from your cashflow and budget forecasts how much cash will initially be needed by the joint venture to cover its start-up costs. It will be important to identify the source of those funds. The money might be provided by the joint venture parties themselves or by their parent companies or by other members in their corporate groups. Alternatively, the parties may have arranged to obtain all or part of the initial funding from their bankers or other third parties.

Equity versus loan capital

In each case, the parties will need to decide how the funds will be invested. Broadly, the funds may be invested as either equity or as debt. Usually, the joint venture parties contribute at least part of their investment by way of shares whereas bankers will usually provide finance by way of loans. Venture capital investors may provide finance using share or loan capital but, in each case, they will invariably require enhanced rights to ensure they retain control of the management of the joint venture company.

Loan capital will be repayable to the lender whereas share capital, unless it is in the form of redeemable shares will ordinarily not be repayable by the company to the investor. Some overseas investors may be subject to local rules which limit the proportion of investment which can be provided as loan capital and appropriate arrangements will need to be made to account for this.

Investors' rights of control

The control of the company will normally be in the hands of the shareholders. However, the documentation may provide separate contractual rights of control for the holders of loan stock if required.

Further funding

After the initial investment has been made, the joint venture vehicle may require ongoing funding. The parties will need to agree, in advance, the circumstances in which they are willing to make further investments to cover working capital requirements, development and expansion costs, or losses.

Tax

As well as taking into account the commercial considerations of the parties' financing arrangements, the structure of the finance must be as tax efficient as possible. To achieve this, for example, the financing documents must be carefully drafted to ensure that any interest payable under these documents can be offset against the profits generated by the joint venture.

7. Contribution of assets to the joint venture

Often, one or more parties will contribute non-cash assets to the joint venture. Indeed, the rationale for entering into the joint venture in the first place is often that one party can offer specialist knowledge or assets (in particular, intellectual property), while the other party is in a position to finance the venture in order to exploit such assets.

The precise nature of the assets being contributed by the joint venture parties must be identified. They may be:

- tangible property like buildings, machinery or office equipment;

- intangible property like patents, trade marks, copyright or technical knowhow.

It will be important for the parties to agree the values of all non-cash assets at the outset since the value placed upon them will often determine the equity share of the party contributing them.

Alternatively, instead of transferring assets outright to the joint venture vehicle the parties may prefer to lease (in the case of property) or license them (in the case of intellectual property rights) to the joint venture vehicle. In these circumstances, the party contributing the assets may receive value for its contribution by way of a rental payment or licence fee and the contribution of such assets will not count towards a subscription for that party's equity share in the joint venture.

Again, tax must be considered when determining the timing and method of contribution of these assets. In particular, if the assets have gained value in the hands of the joint venture partner which is contributing them, there may be a capital gains tax charge when those assets are transferred into the joint venture entity. Value added tax may also be relevant and its effect should be considered.

8. Managing the joint venture

Since all the parties to the joint venture will probably have contributed valuable assets in one way or another and will be making a commitment to contribute resources throughout the lifetime of the joint venture, each of them may want to be able to influence the ongoing management of the venture.

This concern is particularly relevant where the joint venture is structured as a 50:50 "partnership".

The parties will need to consider:

- Who will be on the board of directors?
- Who will have the power to appoint and remove directors from that board?
- What constraints will affect the power of the board to take strategic decisions and to manage the joint venture?
- Will responsibility for day-to-day management be delegated to a managing director or management committee?
- Will one of the joint venture partners take responsibility for day-to-day management, perhaps under a management contract entered into with the joint venture entity?

It is usual to include, in the joint venture agreement, a list of actions which cannot be taken by the company without the approval of each of the parties. These matters are usually those things which would change the nature or scope of the joint venture or which would involve financial exposure in excess of that which would be expected in the ordinary course of business.

9. Dealing with deadlocks

In certain circumstances a deadlock may arise. This occurs where the parties disagree over an important issue relating to the joint venture, for example when it is impossible to obtain a decision at director or shareholder level because the votes for and against a particular motion are equal, or where one party frustrates the decision-making process by failing to attend meetings so that there is no quorum.

Various mechanisms for dealing with a deadlock can be employed in the joint venture agreement, including:

- giving the chairman a casting vote;
- referring the matter to an independent expert or arbitrator;
- referring the matter to senior persons in the management of the joint venture partners;
- a "Texas shootout" provision which results in one party being bought out by the other by virtue of one party serving a notice on the other party declaring a price per share at which that party is willing to both sell its own shares or buy the other party's shares. The other party must then choose one of those options.

Alternatively, some joint ventures adopt the "nuclear deterrent" approach whereby there is no mechanism for resolving the deadlock except by reaching a unanimous decision or by terminating the joint venture and distributing the assets of the joint venture vehicle between the parties.

10. Minority protection

If one of the parties holds less than 50 per cent of the equity shares, it will be concerned to ensure that constraints are placed upon the other parties to prevent them from using their voting rights (at board and/or shareholder level) in a way which unfairly prejudices the position of the minority shareholder. Common ways of protecting a minority shareholder include:

- preventing the issue of further shares by the joint venture which will dilute the shareholding of the minority shareholder;
- giving the minority shareholder the right to representation on the board of directors;
- requiring unanimity (or a special majority) at board or shareholder level for certain decisions;
- prohibiting the sale of shares by the majority shareholders to a third party investor unless the shares of the minority are included in the sale on the same terms ("tag along rights");
- giving a right to certain information about the joint venture and the joint venture parties;
- provisions relating to the transfer and valuation of shares.

11. Transfer of shares

It is likely that each of the parties will wish to prohibit the other parties from transferring their shares in the joint venture vehicle to a third party without first obtaining their consent. Otherwise, if the shares were freely transferable, a party may find itself participating in a joint venture with a third party on whom it has not had an opportunity to carry out due diligence.

On the other hand, the parties will often want to retain some flexibility. For example, it is common to find provisions which allow exceptions to the absolute restriction on the transfer of shares by allowing transfers to other members of the same group of companies or transfers to third parties after the shares have been offered to the other joint venture parties on a pro rata basis.

12. Exit strategies

Planned exit

The parties will often wish to lock each other into the joint venture for at least a limited period by restricting the transfer of shares. However, it is likely that they will each want to be able to bring the joint venture to an end in certain circumstances in accordance with an agreed exit strategy. By way of example, the following types of provision may be included:

- the parties may agree that the joint venture will continue for a fixed period of time, perhaps until a one-off project is completed;
- one party may have the right to buy out another party, or to sell its shares to another party at a pre-determined price or at "fair value" determined by an expert using agreed valuation parameters.

Early termination

The parties should also plan what to do in the event that the joint venture is not working out as they intended. For example:

- there may be circumstances where the joint venture will automatically terminate, perhaps where an essential regulatory approval is withdrawn or if one of the parties gets into financial difficulties;
- each party may have the right to terminate the agreement if the other party commits a default by breaching a condition of the joint venture agreement or where there has been a change of control of a party.

In contemplation of the termination of the joint venture agreement, provisions will often be included to determine the distribution of the assets (including any intellectual property) of the joint venture vehicle and the discharge of any of its outstanding obligations.

13. Principal documents

The documentation required to create a joint venture will depend upon the nature and complexity of the particular transaction. Typically, the following documents are needed.

The joint venture agreement

This is the main agreement which sets out the commercial arrangements between the parties in relation to the joint venture vehicle. It will include the terms upon which they will manage and develop the business. If the joint venture vehicle is a company, this agreement will state how many shares each party will subscribe for and will include the management rights of each party (e.g. to nominate directors to the board). It will also set out the financing arrangements and deal with the constitution of assets, minority protection provisions, termination and party exits.

The articles of association of a joint venture company

The articles of association of the joint venture company will need to be tailored to the parties' requirements. It may be necessary to create separate classes of shares or to entrench voting rights to protect a minority party's rights. Consideration of whether terms should be included in the articles of association or in the joint venture agreement is important but, in general, any aspects of the transaction which the parties wish to keep private should be included in the joint venture agreement and not put in the articles as there is a statutory requirement to file the articles of association with the Registrar of Companies.

Funding agreements

The initial funding arrangements for the joint venture will usually be set out in the joint venture agreement. However, detailed provisions regulating any loans to be provided by the parties or third party providers will often be documented in a separate funding agreement. The joint venture agreement may also deal with the obligations of the parties to make further cash injections by way of working capital. If the funding is made using loan notes or loan stock instruments, documents recording these arrangements will also need to be drafted.

Service agreements

The parties will often wish to agree the terms on which the principal executive officers of the company will be employed by the joint venture. Clearly, the relevant executives will also need to review these terms of employment before accepting their appointments and time should be allocated for this process.

Supply or service agreements between the joint venture vehicle and the joint venture parties

In the early stages one or more of the parties will often provide services to the joint venture vehicle. For example, a party may provide the payroll or invoicing facilities or maintenance services for key equipment, office space or carry out the day-to-day management on behalf of the joint venture. However, as competition law dictates that any agreements to provide such services should only last for a transitional period during the start-up phase until the

joint venture establishes its own systems and should not be exclusive, these arrangements should be documented carefully.

14. Conditions

The joint venture agreement may be subject to conditions. It is important to understand the distinction between pre-contract conditions (those matters that the investor will want to know have been satisfied before it enters into any agreement whatsoever) and a conditional agreement which is a binding agreement, but which will not be completed until the conditions set out in it have been fulfilled or waived by the party in whose favour the conditions have been given.

Examples of "pre-contract conditions" might be the completion of all legal and financial due diligence or the obtaining of fax clearances.

In contrast contractual conditions might require:

- a foreign company to obtain relevant government consents and approvals from its home jurisdiction;
- UK competition authority clearances to be obtained;
- European Union competition law and any other foreign clearances to be obtained;
- the approval of the transaction by the shareholders of a party (for example, if that party has a premium listing on the Official List of the UK Financial Conduct Authority where the size and nature of the transaction is such as to trigger shareholder approval requirements).

15. Restrictive covenants and protection of goodwill

To protect their investment and their own businesses, each party will wish to ensure that the other parties do not compete with the joint venture. This will be particularly relevant where the joint venture has contacts or technical knowhow which could be exploited independently by any of the parties. This often results in undertakings by the parties being included in the agreement to the effect that each will:

- not carry on any form of business which competes with the business of the joint venture company;
- not solicit or entice away any customers, suppliers or employees of the joint venture company;
- not use any trade names or other intellectual property owned by or licensed to the joint venture company;
- not use or disclose to any third party any confidential information concerning the joint venture company.

To be enforceable under EC and UK law, such undertakings must be reasonable in scope, duration and geographical extent. If the restrictions are too extensive they could be held to be anti-competitive and, as a result, may be void and unenforceable which could lead to penalties and/or other actions against the parties. Therefore, careful consideration needs to be given to the wording of the restrictive covenants to ensure that the legitimate interests of the buyer are adequately protected.

16. Conclusion

Each joint venture will be different depending on the business rationale for it. The cash, assets or skills each party proposes to contribute, their long-term goals (including any plans to leave the joint venture in the future), and their relative bargaining strengths will influence the choice of legal structure. Often, this will result in a private limited company being created with shares held by each of the parties, but this is by no means the only model for an effective joint venture. Your lawyers will be able to explain the various options and advise of any pertinent regulatory issues to allow you to choose the legal framework which best reflects your own commercial vision and that of your joint venture partners.

Appendix 1

About this briefing

This briefing forms part of a series of briefings written about corporate issues by Ashurst for international investors. The briefings in this series are:

No. 1 Establishing a Business in the United Kingdom

No. 2 Acquisition of Private Companies in England and Wales

No. 3 Acquisition of a Business in England and Wales

No. 4 Why List in London?

No. 5 Takeovers - A Guide to the Legal and Regulatory Aspects of Public Takeovers in the United Kingdom

No. 6 Joint Ventures in England and Wales

No. 7 A Brief Guide to AIM

No. 8 A Brief Guide to Corporate Insolvency in England and Wales

No. 9 Private Equity Transactions: Overview of a Buy-out

If you would like further information on the matters referred to in this guide or to receive additional copies of this or any other briefing in the series, please speak to your usual contact at Ashurst or:

Brian Murphy, Counsel
T: +44 (0)20 7859 1765
E: brian.murphy@ashurst.com

www.ashurst.com