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TO FORM AN ENTITY OR NOT TO FORM AN ENTITY, THAT IS THE QUESTION; DECIDING BETWEEN AN ENTITY JOINT VENTURE AND A CONTRACTUAL STRATEGIC ALLIANCES

To Our Clients and Friends:

People often speak of forming a joint venture as if the meaning of the term "joint venture" is self-evident. However, the term "joint venture" can be used to describe a wide array of arrangements between two or more parties. The universe of these arrangements can be divided into two broad categories: joint ventures that are implemented solely through contractual arrangements, which we refer to as "Contractual JVs," and those in which the parties jointly own one or more entities, which we refer to as "JV Companies." Therefore, one of the first questions that the parties and their counsel should consider when developing the joint venture structure is "Will the joint venture be solely contractual or will the parties each own a stake in one or more legal entities that conduct the joint venture business?"

A JV Company Is a Substantial Undertaking

Establishing a JV Company offers a number of advantages that may be difficult to achieve through a Contractual JV. For example, a JV Company may make it easier for the parties to share assets to be used in the venture business, manage liability risks associated with the business and establish a management team that is focused solely on the venture. But establishing a JV Company may also be significantly more complex than forming a Contractual JV; this complexity may make a JV Company more expensive and burdensome for the venture parties than a Contractual JV.

Some of the reasons for the additional complexity include the following:

- *Additional Negotiation and Documentation*: In addition to agreeing on the economic terms of the joint venture, the parties have to negotiate and document the governance arrangements of the JV Company, their obligations to make contributions to, and rights to receive distributions from, the JV Company, and the terms and conditions under which a party may exit the joint venture, such as through a transfer of joint venture company equity or a sale of the JV Company.

- *Operational Burdens*: Operating a JV Company imposes burdens on the parties that they may not have in connection with a Contractual JV. Among other requirements, the JV Company may have to obtain required licenses and permits, design and implement internal controls and procedures, produce its own financial statements, maintain its corporate existence and books and records separate from those of the parties and, as noted below, employ a workforce, appoint officers and retain a managing board. These burdens will increase both the time and expense required to run the joint venture.

- *Governance Issues*: Depending on the governance structure of the JV Company, the management decision-making process can also be much more involved than in a Contractual JV. The parties must develop and implement mutually agreeable governance arrangements, potentially at the board and senior management levels, and each party must devote time to overseeing the venture. Procedural requirements, for example, requirements for calling and conducting board or member meetings and taking board or member action, must be complied with or waived. As the number of members of the joint venture with governance rights increases, so does the potential complexity of the JV Company's governance arrangements as well as the potential for disputes about decisions the board and/or the members must make.

- *Issues Associated with Terminating and Unwinding the Venture*: Terminating a joint venture structured as a JV Company may be more complicated than terminating a Contractual JV. Unless the JV Company will be sold to a third party, the venture parties must decide what to do with the JV Company itself, how to provide for its liabilities and how any remaining JV Company assets will be distributed among the parties. For example, will tangible assets be returned to the party that contributed them to the JV Company? Who will receive and/or be entitled to use any JV Company intellectual property? If the venture business will not be continued by one of the parties, they must wind it down and take any related required actions, such as terminating the JV Company's employees, notifying the JV Company's creditors, etc.

It is important to note that the factors outlined above are generalizations, and this discussion is not intended to suggest that Contractual JVs are inevitably simpler than JV Companies, or that formation and structuring issues arising in connection with Contractual JVs are more easily resolved than those involving JV Companies. Contractual JVs may present issues and impose burdens on the venture parties similar to those described above. For example, the various contractual arrangements necessary to manage a complex Contractual JV can look like, and be just as difficult as, governance of a JV Company, with each party appointing representatives to a managing board that oversees the venture business. Similarly, terminating a Contractual JV can raise issues like those implicated by terminating a JV Company if the parties' business operations are significantly intertwined.

Deciding between a JV Company or a Contractual JV

The following list of questions is intended to help potential venture parties evaluate whether a JV Company or a Contractual JV is the best way to achieve their joint venture goals. It may also help the parties identify areas where they have differing views about the proposed joint venture. It is neither an exhaustive list nor one that can always be ticked through in a linear fashion as many of these considerations are related and/or address overlapping issues.

- *Scope of the joint venture*: Will the joint venture operate a stand-alone, self-sustaining business with many moving parts, such as designing, manufacturing and selling products all over the world, or will it have a simpler purpose, such as supplying a particular product or service to one of the parties? Will the venture business be large in scope, or relatively small? The more complicated and expansive the enterprise, the more likely it is that a JV Company structure will be appropriate. The simpler the purpose of the joint venture, the more likely it is that it can be structured as a Contractual JV.

- *Need for significant investment*: Will the joint venture require significant capital expenditures or investment to be funded by contributions from both parties, for example, to conduct research, build facilities or purchase equipment? If yes, it may make sense for a JV Company to own the assets that are created with this investment.

- *New line of business, products or markets*: Do the parties plan to pool their respective resources and/or combine complementary assets to develop a new business (*i.e.*, one that no party currently engages in)? As was discussed above in "Need for Significant Investment," if joint efforts are required to create a new business, it may make sense to establish a JV Company through which the parties can jointly own the venture business.

- *Role of the parties*: Do both parties expect to have significant input into management decisions regarding the joint venture business? If yes, it may be easier for the parties to provide such input if the venture business is run by a JV Company, rather than by one of the parties in a Contractual JV.

- *Need for dedicated management team*: Will the venture business be sufficiently complex that it should be managed by a separate team focused only on the venture business, rather than by managers who are juggling responsibilities to the joint venture and one of the parties? Will the joint venture benefit from a separate compensation structure tied to performance of the venture business to incentivize the management team? If the answer to either question is yes, then this would support a decision to establish a JV Company.

- *Need for separate employee base*: Will the joint venture need employees who are focused solely on the venture business? Or can the venture business be run just as, or more, efficiently by employees of one or more parties? If the former, this fact would support establishing a JV Company. If the parties are contemplating transferring employees to the JV Company, they should also consider the willingness of their employees to work for the JV Company. Employees may be reluctant to leave an established company to work for an unproven one.

- *Intellectual property considerations*: Will the joint venture develop intellectual property to be used primarily in its business, such as new product designs or trademarks, and/or will the parties contribute certain existing intellectual property to the joint venture? If yes, the parties may wish to form a JV Company to control these intellectual property assets, maintain applicable intellectual property registrations and otherwise protect the joint venture's intellectual property rights. However, a JV Company may not be required if new intellectual property is not needed for the joint venture business, or if the intellectual property to be used in the joint venture will be owned and controlled solely by one party.

- *Liability concerns*: Will the joint venture business generate significant liability risk? If yes, the parties may want to own the business through a JV Company to help develop a liability shield.

- *Foreign law concerns*: Will the joint venture operate in a jurisdiction that curtails foreigners' rights to conduct certain businesses or own property? For example, Canada restricts the ability of non-Canadians to own and control Canadian telecommunications carriers. China limits the percentages of businesses in the financial sector, such as banks, securities firms and insurers, that foreigners may own. If such restrictions will prevent one of the parties from owning the venture business, a Contractual JV may be the more attractive option.

- *Ability to transfer assets to the venture:* If the venture business requires the use of assets owned by the parties, can these be transferred easily? If there are encumbrances preventing the transfer of these assets, such as pledges to creditors, a Contractual JV may be a better choice.

- *Regulatory issues:* Is the venture business in a highly regulated industry? Does it require licenses that cannot be transferred, specialized employees and/or substantial infrastructure designed to ensure compliance with applicable laws? If yes, and one of the parties already has such licenses, employees and/or infrastructure, it may be desirable for that party to continue to run the business, rather than transfer it to a new company.

- *Strategic objectives*: What are the parties' respective strategic objectives? Does the venture represent an opportunity for one party to learn about a new business? Or for a party to gain access to new funding, technology or markets? In some cases, it may be easier for a party to achieve a strategic goal if a JV Company is established. For example, let's assume that the venture will be the sole supplier of raw materials to one of the parties. That party may want the venture business to be contributed to a JV Company so the party can exercise more control over the business and have the option to buy out the other party in the event of any dispute between them. Another example is an arrangement under which one party will adapt technology developed by the second party for use in the first party's business. In this context, it may make sense for the first party and the second party to form a JV Company, because joint ownership of the enterprise may make it easier for the first party to learn about the technology and control its commercialization.

- *Term of the joint venture*: Do the parties expect the joint venture to have an extended or indefinite life? Or is the venture being formed to take advantage of a short-term opportunity? If the joint venture is expected to have an extended life, a JV Company may be the better choice.

- *Exit plans*: Do the parties have a specific plan for how they will exit or terminate the joint venture? For example, do they envision growing the venture business for several years and then selling it to a third party or taking the business public? Is one party hoping that it can eventually buy out the other party's interest? Is the other party hoping that it can exit the business after participating in the joint venture for a period of time? In these circumstances, it may be easier to develop exit plans if the parties establish a JV Company.

Tax Considerations

Tax planning is a critical element of venture planning, and parties would be well-advised to involve tax counsel as early as possible in the venture planning process. Parties that form a Contractual JV should be aware of the risk that a Contractual JV may be treated as a separate entity for federal income tax purposes. Generally, an arrangement under which the participants jointly conduct a business and share profits and losses will be treated as a partnership under the Internal Revenue Code. (If a Contractual JV is such an arrangement, the parties can elect to treat the arrangement, i.e., the Contractual JV, as a corporation instead of a partnership for federal income tax purposes.) Factors that courts consider when evaluating whether a Contractual JV is a partnership for federal income tax purposes include, among others, each party's contributions to the venture, who controls income and withdrawals, if the venture is conducted in the joint names of the parties and if the parties have mutual control over the venture. Significantly, if a Contractual JV is treated as a separate entity for federal income tax purposes, there is also a risk that a party's activities that the parties do not consider to be part of the venture are nonetheless treated as part of the Contractual JV for federal income tax purposes. These risks may result in unintended tax consequences. In contrast, forming a JV Company provides certainty about what activities will be treated as part of the venture, and such certainty will make tax planning easier.

By bringing more certainty to the taxation of the venture, the creation of a JV Company may also offer more opportunities for tax planning than a Contractual JV. This is particularly the case in the cross-border context; if the venture will involve operations in multiple countries, it may be advisable to form multiple local-country entities to manage their tax liability. Moreover, recent changes to the tax law, particularly those changes impacting the taxation of non-US income earned by US taxpayers, require particular attention.

Conclusion

The decision whether to establish a JV Company or a Contractual JV is not always easily made. There is no formula that can be applied to produce the right result. Although the answers to the questions posed above do not invariably dictate whether a JV Company or a Contractual JV will be the best structure, they may provide valuable insight. In some instances, one approach will have clear advantages over the other. However, in most situations, the parties will be able to be accomplish their objectives through either a JV Company or a Contractual JV. In these cases, the parties must balance a number of potentially competing considerations, and then make a judgment call.

Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work or the authors of this alert:

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