

International Joint Ventures (Part I)

(Relevant to AAT Examination Paper 6 – Fundamentals of Business Law)

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What is a joint venture?

Managers of international companies may want to enhance the company's competitiveness in the global market. Forming an international collaborative venture has become a common business strategy in recent years. There are many examples of these international alliances. Shanghai General Motors Co Ltd is a joint venture between General Motors and Shanghai Automotive Industry Corp Group in China. Sharp Corporation and Sony Corporation formed a joint venture (Sharp Display Products Corporation) to produce and sell large-sized LCD panels and modules. In the bottled coffee drinks industry, Starbucks and PepsiCo have formed a new joint venture, International Coffee Partnership, to address the Frappuccino coffee market outside North America using Pepsi's established beverage distribution channels. Starbucks Coffee Company has also signed an agreement to form a joint-venture company with Ai Ni Group (the largest coffee operator in Yunnan) to purchase Yunnan coffee beans.

There are a number of reasons for forming such alliances. These ventures are more or less like symbiosis where one firm co-operates with the other and both mutually benefit under the interaction. International firms would like to expand and explore new business opportunities abroad. But they may lack knowledge of the local business environment and may not have the goodwill. By collaborating with local firms, they could benefit from the latter's distribution channels or brand names. An association with local firms reduces the risks of entry and enables the firm to gain local expertise. Firms may acquire production factors such as labour forces or raw materials that are cheaper in foreign market and this could complement their own resources. By reducing production costs, firms could create economies of scale as well as economies of scope. The location may be nearer to the potential customers. Sometimes, governments encourage foreign investment by providing incentives like tax concessions and subsidies. Trade barriers and tariffs may also be avoided.

On the other hand, by collaborating in research and development, manufacturing and marketing, local firms may obtain access to new technology and management techniques and know-how from the foreign investors. They can learn how to develop and market products and create international brands.

"Joint venture" is a flexible concept and there is no generally accepted definition for the term. It simply means a joint task or business where some kind of risk or danger is involved. The partners in this commercial undertaking will have to share the risk. The participation of parties in an international joint venture is usually of long-term duration and, in some cases, there may be no time limit provided for the alliance. An international joint venture or strategic alliance can take many forms. The common characteristic is that while the parties remain independent from each other as separate entities, they are also mutually interdependent in the joint task. By pooling resources, value is created and

each of the parties could obtain monetary or other benefits that they alone could not achieve. The range of organizational form is broad. The most common ones are equity joint ventures and non-equity cooperative alliances. But other co-operative arrangements like licensing arrangements, franchising and distributorship agreements are also possible.

Foreign investors firstly have to identify and select prospective partners and then develop strategic plans with them. Some important legal issues have to be considered in forming an international joint venture, such as:

- the legal environment in the host country and the implication on foreign investors;
- the business structure of joint venture;
- the legal procedures in formation;
- drafting issues in the joint venture agreement; and
- how the joint venture is managed taking into account cross-cultural aspects.

Note that the term “partner” is used in a loose sense in international business. It does not necessarily refer to a partner in a partnership created under the Partnership Ordinance. In this article, the terms joint venture partners, joint venture parties and joint venture participants are used interchangeably.

The legal environment in host country

The joint venture partners have to consider the various national laws and regulations in the host country that govern joint venture business. Joint venture corporations in Hong Kong, for example, have ongoing obligations under the Companies Ordinance such as holding an annual general meeting and filing an annual return with the Companies Registry every year.

Commercial law is a vast area which formulates the rules for business transactions. The joint venture parties have to consider contract law, which is the foundation addressing the rights and obligations between them. Foreign firms may negotiate and choose the law of their country as the governing law for the contract. The sale of goods law applies when the joint venture buys raw materials from a supplier or sells manufactured products to buyers. In the context of international business, the United Nations has a set of uniform contractual terms for the international sale of goods. Parties could make reference to these standardised provisions under the United Nations Convention on Contracts for the International Sale of Goods (CISG, the Vienna Convention). Similarly, parties have to consider various aspects of international trade and can refer to UNCITRAL's (United Nations Commission on International Trade Law) legal framework and model laws on international payment like international bills of exchange and international transport of goods like international carriage of goods by sea.

By establishing factories in the host country, a joint venture owns property and invariably employs members of the local labour force. The joint venture will be subject to national real and personal property laws and this includes for example law on the transfer of title, regulations on land usage, law on mortgage of property whether movable or immovable,

and protection of intellectual property rights. In addition, rules and regulations on employment, minimum wages, health and safety at work, and environmental protection like regulation on smoke emissions will have to be considered.

Under the Basic Law of the HKSAR, the Government of the HKSAR will provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre (Article 109) and the free flow of capital within, into and out of the HKSAR is safeguarded (Article 112). But in other countries, such as some developing countries, there may be restrictions on foreign investment activities and exchange controls. In some of them, the national laws may not allow foreign investors to fully own a business operation. The financial impact of tax law is another issue for consideration. In Hong Kong, we have low tax and a simple tax system. The joint venture parties have also to consider how to resolve any disputes in the event that disagreement arises.

The business structure

The joint venture parties have to select a suitable business structure. They have to consider the possibility that the business may not generate income and may suffer losses in its early years of operation. The parties have to think about the question of liability and allocation of risk. In subsequent years when profits are generated, they have to consider allocation of profit and other issues like whether the withdrawal of one of the parties will affect the continued existence of the joint venture.

Whether the host country is a common law or civil law country, two basic types of entities are commonly found: corporations with limited liability for owners, and associations with unlimited liability for partners. The former is sometimes called an equity-based venture and the latter non-equity-based venture or international co-operative alliance.

In Hong Kong, partnership is defined as the relation which subsists between persons carrying on a business in common with a view of profit (section 3 of the Partnership Ordinance). There is no formality in setting up a partnership. The joint venture parties should however negotiate a partnership agreement which will provide the terms on the relationship between them and set out their rights and duties in the business, such as on how to conduct the business, how to obtain finance and how a partner would retreat from the business if the partners were not in good terms. Partners are jointly and severally liable for the debts of the firm. In *HKSAR v Gammon Skanska Limited* (2003), the joint venture was an unincorporated association. The court had to consider whether it could or could not be guilty of a criminal offence and concluded that an unincorporated association cannot be a defendant to criminal proceedings.

If the joint venture business is a registered company, it is in law a separate legal entity distinct from its members, *Salomon v Salomon Ltd. (1897)*. Its activities will be separated from the core business of joint venture parties. The contribution to the corporation is usually 50/50 between participants of equal bargaining power although any other combination is possible.

The company is liable for its own debt and the company's liability is without limit. Both the foreign investor and local partner will not be personally liable for the company's debts. The liability of shareholders is only limited by the memorandum to the amount, if any, unpaid on the shares held by them. No contribution shall be required from any member exceeding the amount unpaid on the shares in respect of which he is liable as a present or past members (section 170(1)(d) of the Companies Ordinance). Thus if the business fails, the principle of limited liability means that the problem will not affect the joint venture participants. Each of their losses is limited to the amount they have invested and any amount unpaid. The investors' assets are insulated from the liability of the joint venture company. Also, as it is a separate company, the joint venture has a strong and independent identity when it deals with third parties. It can borrow money by way of a floating charge.

In part 2 of this article, other issues including legal procedures in the formation and clauses in the international joint venture agreement will be discussed.