International Distributorships and Joint Ventures

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For some time I have been uncertain as to what to say to you as a commercial generalist that will be useful. The areas of distributorships and joint ventures are very broad and involve many disciplines.

When I was asked to participate in this session, my initial reaction was to do the same thing I have done before in speaking about foreign joint ventures, and to talk about what most lawyers in the area lecture and write about: favorite legal issues, which should be either exotic or forbearing. Extra-territorial effect of United States laws; strange forms of foreign legal entities we have known; intricate drafting problems involving onerous foreign distributorship termination laws; and the three old standbys—governing language, governing law, and complex dispute-resolving mechanisms.

In gathering the material I couldn't help being struck by the recurring thought that while all of these issues are important, they do not reflect the fundamental problems experienced in practice. One article I read in preparation particularly crystallized my concern over basic relevancy, but it appeared reflective of what most authors address. It is from one of the California law reviews and carries an enticing title: "Protecting the Entrepreneur: Special Drafting Concerns for International Joint Venture Contracts." The title sounds terrific and the preamble even better:

> *International joint ventures expose investors to the precariousness of international and foreign law. Normal contract execution and enforcement are threatened by the capacities and weaknesses of international law institutions, as well as by the legal-political system of the host state. This comment discusses the importance of specific contract clauses, and suggests a two-step drafting approach, conflict avoidance and risk minimization, to protect the investor.*

At that point I thought my preparation for today was over—I'd just read you the article. Unfortunately, when I read it, I was struck that the issues discussed didn't cover the fundamental problems, and too much was said about real issues, but not issues that destroy a deal:

- *American vs. foreign approach to drafting*: yes, there are cultural and training differences—American lawyers tend to write too much; but no, the difference has never stopped a deal. What is important to remember is to get cultural advice from local lawyers and other U.S. businesses; to be sensitive but to not be fooled by the old standby "we don't do it that way"; and to be patient.
- *Governing language*: yes, the agreement must be written in language; no, it is never a real issue.
- *Governing law, choice of forum, dispute-resolving mechanisms*: all important to consider, but none ever helped put a deal together, or stopped a deal, or held a deal together.
- Finally, *notarial form requirements*: yes, there are often requirements to use a notary—what else can you say.

What this article reflects is what many lawyers think about when their client says "international," when what *should* be thought about is what is the business objective: how can I help put a deal together, keep it together, and best provide for changes that inevitably occur?

What I would like to do is talk to you about problems my clients and I have encountered in putting and keeping together foreign distributorships and joint ventures. Through this, I will give an overview and note the principal

Based on a speech given in 1987 by Pillsbury chairman Alfred L. Pepin, Jr.

issues. I will speak of distributorships and joint ventures as general categories, when in fact there are many forms of distribution agreements—representatives, agents, distributors, and various combinations—and equally many forms of joint venture arrangements—ranging from associations governed by agreement to complex combinations of formal legal partnerships and limited liability companies.

Defining realistic goals and selecting the right structure

The first problems I have experienced relate to defining the business objectives and failing to implement realistic objectives. Such failures result in transactions which are incompatible with a client's needs, and transactions beyond a client's resources to administer properly.

There are many typical goals for entering into a foreign distributorship arrangement or joint venture.

- One is to acquire an immediate *access* to a foreign market. Many firms wishing to enter a market do not have the time to develop the resources to enter and be a factor because they are behind local or other international competitors. Therefore, they look for someone who is already there as a distributor or a joint venturer.
- Another typical objective is to *reduce the commitment*; funds and manpower may be short, and joining with another helps to satisfy the commitment.
- A related objective is often to spread and *minimize the risks*. If the client is unsure of the acceptance of its product in the foreign market or of its ability to compete otherwise in that market, joining with others will reduce its exposure. Others believe that if they join with a local foreign company as a distributor or as joint venturer, local acceptance will be better and relationships with the public, government and labor will be smoother.
- Other occasions for distributorships and joint ventures include *acquisition of a foreign resource*: knowledge of local market and local personnel and facilities in distributorship arrangements or capital and technology in a joint venture. Still others seek only to assure an outlet for the investor's product.
- Other reasons include *compliance* with foreign laws dictating a local equity content, and *pooling of skills* to compete with larger competitors.

I find that many legal problems can be traced to a lack of appreciation of realistic objectives and mismatching of legal structure with objectives.

For example, a small startup company with its very limited resources, both financial and manpower, and with great pressure on those resources has, in many situations, questionable business being in a foreign joint venture that, if administered properly, requires manpower to monitor, and financial resources to participate fully in future venture opportunities. The lack of manpower to monitor will give rise to control disputes. The lack of financial resources will result in friction in consideration of future expansion and the handling of new venture opportunities. There will also be pressure on profit payout. What is oftentimes better suited for a startup is a license, agency or distributorship, where control is more easily manageable and the financial commitment more readily predictable.

Some time ago, at that time a small Sunnyvale client taught our firm a lesson on clearly perceiving realistic objectives and structuring a transaction to fit the objectives in order to obtain a fair chance at success. The client was essentially a startup company. It had a black box that was useful in a highly specialized segment. It had the manpower to market it in the United States. It knew that a similar market existed elsewhere, particularly Europe, but lacked knowledge of the market, access to the players, and resources at that time to play even if it could get into the game.

Through enough market research the startup determined and sought out a very large German multinational that had everything but a new enough black box. The multinational made very enticing offers with regard to acquisition and joint venture. The client refused, because it was

wise enough to understand that it would have simply been overwhelmed in the venture by the multinational's manpower and resources. Moreover, a joint venture would have given the multinational greater involvement in the technology of the black box than was comfortable for the startup.

The transaction was structured therefore as a form of a relatively short-term distributorship agreement. Payments were structured so that the agreement was bankable, satisfying the client's need for funding. The multinational undertook performance obligations that featured the client's trademark, allowing the client to get exposure with the foreign market. Permits and clearances required by government authorities were obtained in the name of both parties. Through information dissemination obligations undertaken by the multinational, the client was enabled to discern a great deal about the foreign market. As the client grew, it was able to absorb increasing amounts of information so that if it chose to do so, it could become an independent factor in the market. Through control and confidentiality restrictions, the technology was preserved as much as practicable. The multinational wasn't entirely frustrated—it obtained an opportunity to be associated with the newest technology. It had a chance to investigate the new company and test its people and technology, and to be the first to establish an important working relationship. In short, a good chance for success was achieved because realistic objectives of both parties were mirrored in the structure and terms of the transactions.

I bring to you two examples of transactions that failed because of a mismatch of objectives and legal structure. A client of our firm entered into a very long-term European marketing joint venture solely to ensure an outlet for manufacturing facilities it acquired as still another joint venture it was in terminated (because its partner acted in conflict with that joint venture, either taking or minimizing the venture's business opportunities). The new venture was more than equally painful because of the inherent conflict of interest that occurs when one of the venturers is the sole supplier to the venture. Paramount among the causes of the conflict was the product transfer price. Time passed and the pricing mechanism simply could not cope. The price was too low and the supplying partner unsurprisingly non-responsive to change quickly. The client was non-receptive to venture growth because the more the venture grew and sold, the worse the client felt the loss under the transfer price. Because of the long term of the agreement, a buyout at a very significant loss was eventually the only alternative.

The second example was an African venture on which we spent extensive time that was also plagued from the outset by conflicts of interest, resulting from an investor that was both the primary venture lender and an equity holder—not an entirely unusual situation. The problem resulted in that instance from the investor's inability to separate its lender's role from that of an equity risk taker. All moves by the investor with regard to expansion and other equity risk-taking were colored by its views in protecting the loan. Clearly this was a case in which that piece of the transaction should have been structured entirely as a loan, with perhaps an option for future equity.

Managing the relationship

The second major area of basic problems I have experienced relates to management of the transaction once it is under way in order to achieve the objectives. The disputes and unsatisfactory results often seen with regard to distributorships result from a lack of understanding as to what is expected in the way of distributor performance. Some agreements do not contain performance objectives, and when the manufacturer is dissatisfied, the agreement offers no guidance as to relief. These problems can be minimized by specifying performance obligations and relating performance to the duration of the agreement. To the extent performance standards are not practical, then the term should be of a clear and unequivocal short duration.

The difficulty experienced in managing objectives in joint ventures is more complex.

Typically the challenge is the proper monitoring of the venture's activities, and the need to structure the venture decision-making mechanism to protect the investor's objective. Joint venture arrangements should include provisions that provide all participants with access to information as to the venture's performance. The extent and detail of the information will depend on the nature of the venture, but all participants should have equal access. In situations in which this does not occur, there are inevitable misunderstandings. Problems arise because the participant with the greater access is perceived as taking advantage or having the potential to take advantage over the other.

A word about the practicalities of monitoring: the agreement can be perfect in this respect, but it will not be useful if the investor doesn't pay attention to the store. Hence, I seriously question whether joint ventures are appropriate for small, startup companies. The thought applies equally though to large companies.

Our firm represented a very large multinational in a dispute with its partner in a large multinational Canadian joint venture. We wrote the shareholders' agreement for the joint holding company, and endeavored to provide adequate monitoring devices. Unfortunately, hardly anything is adequate if the provisions are ignored, and the client for over ten years treated the venture with benign neglect. While the venture initially flourished and the neglect was painless, as problems arose it became more painful—particularly when the client now wanted to be active and manage its investment. This has created a practical and legal problem. The practical problem is how to convince the other participant who was active that the client was now serious and control should be shared. The legal problem is how to resurrect the protective terms that by conduct the client had from a legal standpoint waived, and how to put the client in a position to obtain support under Canadian statutes protecting minority shareholders.

Another aspect of this problem is related to failure of the venture decision-making process to provide protection for a participant's objectives. If an investor is entering a joint venture for a limited purpose, the scope of the venture should reflect that limited purpose. The decision-making mechanism should be such, through veto rights or other forms of extraordinary quorum and voting requirements, to protect against change without the investor's concurrence. We have been engaged in negotiations in Brazil relating to a joint chemical manufacturing facility, when this very issue became a focal point of the negotiations. The client viewed the joint venture as a strategic investment in order to protect existing Brazilian relationships and to ease local pressure concerning the client's other unrelated Brazilian investments. We endeavored to negotiate a shareholders' agreement that limited the financial commitment of the individual participants, restricted venture financing, and limited the ability of the other participants to force the client into an expanded business and away from its objective of a purely strategic investment. The specific drafting mechanisms used were limits on capitalization; specification of a financing plan with provision for internal venture funding and borrowing, rather than participant funding and guarantees; a mechanism for participant election out from expansion; and sole risk provisions for those desiring to proceed, with limited equity dilution for the non-participant.

Managing changes in objectives

The final major problems experienced with distributorships and joint ventures are those associated with changes in objectives. These problems start with many grievances, but usually boil down to one desired outcome: the client wants out.

In distributorships, the basic problem of change relates to termination and the impact of laws providing various forms of protection to distributors. Most of the termination laws are associated with Europe, Latin America, and the Middle East, but they appear elsewhere, and in certain industries domestically. There is no universal solution, but there are measures which will mitigate the impact of such laws. A clear short term without an ambiguous evergreen

trailer will be helpful. Tying a termination provision to performance obligations will help satisfy laws requiring good cause for termination. Selecting an appropriate dispute-resolving mechanism and site for the dispute settlement can help get a fair application of law and remove the matter from local prejudice and glacial process. Selecting an appropriate choice of law to govern termination may on occasion be helpful, but most jurisdictions will hold their distributor protection laws to be matters of public policy that will be enforced regardless of the contract provision. As a practical matter there is a limit as to what you can do, and the question really isn't whether you will pay, but how much.

In joint ventures, the problems of change often manifest themselves in application of rights of first refusal when one of the participants wants to sell. There are many forms of preemptive rights, but in my experience the fairest and least likely to chill a sale is that which requires a participant first to offer its interest to the other participants, and then, after a short specified period, permits sales to others on terms no more favorable than those offered to the other participants. Rights of first refusal that would operate only after a third party purchaser has been found tend to chill sales, because others do not wish to make an effort to bid and expend money in doing so if an insider can end up as the purchaser. It should be kept in mind that there is a practical problem with selling a closely held joint venture interest, since the interest is in the nature of a partnership. The new participant must be generally acceptable to the existing participants or any sale will be chilled and a reasonable price for the interest unlikely.

We encountered a very real example as a client struggled to free itself of a joint venture in Europe. The venture was in essence operated by a European participant that is influential with the local government, which must approve any transfer of interest. The European participant offered a very low price for the interest and, by refusing to provide the adequate operating information and refusing to waive certain confidentiality requirements, is inhibiting a marketing of the interest to others. Moreover, since the European participant is so dominant as operator and influential with the government, its hindrance of the sale would chill any interest of others at a reasonable price; no one wants to buy into a lawsuit or a bad relationship. As a practical matter, therefore, keep in mind that the right of first refusal mechanism must be fair, complete and clear—and even then, an uncooperative participant can chill a sale to others.

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What I have attempted to do is provide an overview of the fundamental problems most frequently experienced in foreign relationships.

- First, the problems of implementing objectives, and finding the best structure to accomplish realistic goals. A solution might be to use a distributorship rather than a joint venture.

- Second, the problems of managing objectives. These can be addressed through performance obligations in distributorships, and structuring the monitoring and decision-making process in joint ventures.

- Third, the problems of changing objectives. Attention should be paid to the termination provisions for distributorships, and to rights of first refusal or other preemptive rights for joint ventures.

I conclude as I began. When you think of international transactions, think of transactions first and foremost. It is the deal that is paramount whether foreign or domestic, for there is simply no other reason for the lawyer to be there.