1. Introduction

1.1 OVERVIEW

The goal of this book is to provide a clear set of analyses that demonstrate how joint ventures are founded upon a sort of "incentive system." Each partner company ("player") participates in a joint venture in order to maximize its own payoff. In order to do so, each player needs to incentivize its partners to provide capital to a joint project. This is a game-theoretic scenario. This book presents three important concepts relating to joint ventures: incentive bargaining;[1] synergy (i.e., three kinds of payoff); and staged bargaining from each partner company's point of view.

A joint venture is a strategic alliance to which each partner company contributes not only a substantial amount of monetary capital but also relation-specific human capital. Each partner company participates in the management of the joint venture. Therefore, each player is both the principal and agent of the other, creating a double moral hazard problem that must be considered. Unless proactive measures are taken, a player may hesitate to provide its own capital, either monetary or human, because of the risk of the other acting opportunistically.

Although there is potential for synergy, the joint venture is a risky project. This book takes a close look at each relevant stage involved in the incentive bargaining between the partner companies, indicating what the successful bargaining strategies are from each partner company's point of view.

This book is divided into four parts. Part I (Chapters 2–5) concerns incentive bargaining: why partner companies need to motivate each other and how they bargain. Then, in Part II (Chapters 6 and 7), synergy is

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[1] Incentive bargaining is the bargaining between the indispensable capital providers of the firm, motivating them to provide the capital they own to the joint project. *See* Zenichi Shishido, *Introduction: The Incentive Bargain of the Firm and Enterprise Law: A Nexus of Contracts, Markets, and Laws, in* ENTERPRISE LAW: CONTRACTS, MARKETS, AND LAWS IN THE US AND JAPAN 1 (Zenichi Shishido ed., 2014).

explored: how synergies are created in practice and how intellectual property (IP) is relevant to creating synergies and to incentive bargaining. Part III (Chapters 8–12) deals with staged bargaining. The form of the partners' incentive bargaining changes as the joint venture progresses through each stage of its lifecycle. Each chapter in Part III describes the important points of incentive bargaining from the practitioner's standpoint, from the pre-contract stage to the termination stage. Finally, Part IV (Chapters 13 and 14) considers the points of joint ventures' success and the future of joint ventures.

1.2 THE STRUCTURE OF INCENTIVE BARGAINING IN JOINT VENTURES

When two or more players start any joint project, they each need to incentivize each other in order to maximize their own payoff. In venture capital-backed firms, monetary capital providers (venture capitalists (VCs)) and human capital providers (entrepreneurs) are categorically separate. The incentive bargaining in venture capital-backed firms involves entrepreneurs trying to incentivize VCs to provide monetary capital while VCs try to incentivize entrepreneurs to provide human capital. The goal is to strike a good balance between the autonomy of human capital providers and monitoring by monetary capital providers.

On the other hand, in joint ventures, each player (partner) provides both monetary and human capital; therefore, monetary capital providers and human capital providers are not separated in the same way. Imbalances between monetary contributions and human capital contributions will inevitably occur, thereby causing an imbalance between the proportion of human capital contributed and the share of the return on investment, leading ultimately to an incentive distortion. Accordingly, the major objective of incentive bargaining is to adjust for this imbalance and provide proper incentives to the partner who provides the more important human capital.

One risky aspect of participating in a joint venture is that conflicting interests between partner companies often arise in situations of self-dealing, corporate opportunity, and disclosure. Because of these potential conflicting interests, each player expects opportunistic behavior of its partner and feels wary about providing its capital to the joint project. From a synergy perspective, one can see how such a risky situation leads to each player pushing incentives to the other so that each provides capital to the joint project. The balance then typically results in the sharing of control, which mitigates risks, and sharing total return as a positive incentive. Making certain exit methods available provides an additional bargaining point related to both sharing control and total return.

Bargaining over how to share control includes making determinations as to the division and sharing of voting rights, board member seats, veto rights, information rights, and exit rights. If the result of this division is that one partner lacks equal control, it will be at risk of a squeeze-out. If both partners have equal control, such as in a 50/50 joint venture, there is a risk of deadlock, although the risk of squeeze-out is eliminated. Therefore, designing the optimal balance of control is important to forming a functional cooperative relationship.

Joint venture partners bargain over sharing total return to maximize synergies realized by each joint venture partner (JV partner), which herein is defined to include return on investment, return from transactions, and any ancillary return. Return on investment is the payoff from equity holdings, consisting of dividends and capital gains. In stock corporations, return on investment is determined by a given partner's share of the total monetary capital investment. The share of human capital is, however, not the same as the share of monetary capital. Without any adjustment, the incentives of the partner that provides the more important human capital will be distorted. In most cases, adjustments are made through return from transactions. Ancillary return, such as "learning effects," also could play the role of a substitute. Each partner company must consider the sum of the three types of return worthy before providing capital, which will, in turn, create the potential for a cooperative relationship.

Bargaining over exit rights is particularly important in joint ventures. Partners should be concerned not only with the amount of capital that the retreating party can recoup, but also with the effect that a threat of exit may have on the sharing of control within the joint venture. So, although it is too risky for partners to contribute resources without any exit rights, granting easily exercised exit rights distorts all partners' incentive to commit to a joint venture because of the excessive risk of one partner exiting in a way that will inevitably be detrimental to the other. Delicate bargaining is required to maintain a good balance between these two extremes.

1.3 SYNERGIES AND INTELLECTUAL PROPERTY

The objective of forming a joint venture is to realize synergies. We define synergies as the sum total of return on investment, return from transactions, and ancillary return for each partner. By this definition, we can discuss maximization of synergies in a game-theoretic context. The three types of return constitute returns or synergies that are unavailable to JV partners individually. They can only be realized by partnering with each other.

Joint ventures can be classified into 11 types based on the JV partners' objectives as described in Chapter 6. These 11 types generally fall into one of two broad categories: joint ventures that are intended to achieve greater efficiencies between incumbent businesses, or those that aim to enter a new business or market.

The cooperation that is required to realize synergies will almost inevitably be accompanied by some competition-restraining effects. This makes antitrust law a key legal obstacle for partners in a joint venture. It becomes necessary to assert that the pro-competitive effects of the joint venture are higher than the anticompetitive effects, and the partners must also comply with the *ex ante* procedural regulations of the jurisdiction where the joint venture is to be established.

Why the partners create a joint venture company (JV company) rather than just entering into a contractual alliance to realize synergies is an important question. Although most synergies can alternatively be realized through a mere contractual alliance, creating a company increases exit costs and the mutual commitment between partners, incentivizing each partner to provide capital to the joint project. Also, where technology licensing is involved, the licensor partners can prevent technology transfer to the licensee partner, and also secure ongoing rights to the products based on the development of the licensed technology, by licensing technology to a joint venture, instead of directly licensing it to the licensee. However, it is not always more advantageous to establish a JV company instead of entering a contractual alliance. Each partner must carefully compare the two alternatives depending on the unique situation.

Intellectual property plays a critical role both in realizing synergies and in incentive bargaining. In most joint ventures, synergies will be realized by combining the parent companies' respective IP, including technology, know-how, and trademarks. The benefits of this human capital investment include financial return in the form of royalties and greater control that stems from the licensing partner's ability to define conditions on the joint venture's use of the IP. The non-licensor partner also benefits from the joint venture, in that the venture may give it the opportunity to profit from the combination of technologies that the licensing partner would not feel comfortable licensing to the other partner[2] directly. However, non-licensor partners should be aware of the fact that a partner licensing indispensable IP rights additionally has strong bargaining power, due to the threat of exit. Finally, when engaging in incentive bargaining over IP licensing, partners should keep in mind the potential tax and antitrust implications of any agreement.

1.4 STAGED BARGAINING

In order to maximize synergies, JV partners must motivate each other to provide monetary and human capital to the joint project, not in a one-shot game, but as part of an ongoing process, typical of long-term relational contracts.

The subject matter and method associated with incentive bargaining changes with the stage that the joint venture is then undergoing. The joint venture lifecycle can be divided into four stages: the preparatory stage; the establishment stage; the operational stage; and the transformation and termination stage.

1.4.1 Pre-Contract Bargaining: The Preparatory and Establishment Stages

Pre-contract bargaining at the preparatory stage generally takes a significant amount of time. Potential JV partners negotiate step by step and commit to each other by exchanging memorandums of understanding (MOU) and/or letters of intent (LOI) to mark areas where they have reached agreement throughout the bargaining process. During this stage, they discuss and make decisions about basic matters, such as the joint venture's business model, the scheme for establishing the joint venture, ways to maximize the three types of return, and basic policies on sharing control and total return. When agreement on these key matters has become sufficiently well defined, the partners create and sign a legally binding joint venture agreement.

JV partners next follow the steps for establishing the joint venture laid out in the joint venture agreement. This "establishment stage" includes the legal establishment of the JV company, the transfer of assets required

[2] The term "the other partner" is generally used herein to describe the other partner in the typical case where there are two partners in the joint venture. However, the same principles would apply in situations where there are more than two partners.

by the joint venture, and the finalization and execution of ancillary agreements.

In these stages, the legal method of finalizing a bargain is practically important. Partners may finalize the result of their incentive bargaining in various contracts, including a corporate charter/articles of incorporation, shareholder agreements and ancillary agreements. As the form and interpretation of these contracts will vary based on the compulsory and default rules of the legal entity that the JV partners choose (e.g., rules regarding charter autonomy and exit option limitations), the choice of legal entity affects the durability of the agreements between partners.

1.4.2 Post-Contract Bargaining: Operational and Transformation/Termination Stages

Incentive bargaining between JV partners continues after the joint venture is established. Post-contract bargaining includes both monitoring and renegotiation. JV partners need to monitor each other to make sure that monetary and human capital are provided as promised, in addition to ensuring that the decision-making process complies with the joint venture agreement. Further, because it is generally impossible for the joint venture agreement to include provisions for every future contingency, JV partners are often forced to renegotiate when new situations arise, such as a change in the market environment, a change in the nature of the joint venture, or a change in the JV partners' relationship. This renegotiation may take various forms, including an additional financial contribution to the joint venture and dispute resolution between the partners. Although renegotiation is indispensable to the survival of a joint venture experiencing a changing environment, expectations that renegotiation will take place may create a hold-up problem.

One important change that may occur during the life of a joint venture is the transformation of its character from a cost-center to a profit-center. Cost-center joint ventures perform cost-cutting functions for the partners, with management strictly monitored by JV partners. On the other hand, profit-center joint ventures are primarily intended to earn profit from third parties and are therefore necessarily given more managerial autonomy. If a cost-center joint venture transforms into a profit-center joint venture, the form of the incentive bargaining changes from two-player bargaining between JV partners to three-player bargaining between JV partners and the joint venture management.

The final stage of post-contract bargaining occurs upon termination of the joint venture. Joint ventures can terminate either by agreement or without any agreement. JV partners may agree to an exit by one or both partners while keeping the joint venture in operation. Dissolution of the joint venture may also be agreed to depending on the situation. Even when conflicts prevent an agreement, a joint venture may be terminated through a buyout/sellout, arbitration, judicial dissolution, or bankruptcy. There are many practical issues for JV partners to consider at this stage.

1.5 THE SUCCESS AND FUTURE OF JOINT VENTURES

1.5.1 Avoiding Common Joint Venture Pitfalls

Although a joint venture can potentially result in synergies that benefit each partner, the success rate for joint ventures is quite low. Successful joint ventures are created when the incentive bargaining between partners provides sufficiently balanced incentives and each partner is satisfied with its total return. Conversely, joint ventures typically fail as a result of a failure in organizational and/or operational management. This book examines some of the major reasons why organizational management fails, so that partners seeking to create a successful joint venture can avoid such pitfalls.

Organizational management failure occurs in several scenarios, such as when there is insufficient incentive to provide capital *ex ante*, *ex post* dissatisfaction with the share of total return, and often times, when there is opportunistic behavior by a dominant partner.

Although several practical and legal measures have been developed to prevent or resolve organizational management failure, the bottom line is that both partners can potentially exit or threaten to do so, and therefore an ongoing relationship of trust between each other is vital, as it allows for a greater possibility of constructive dialog in cases of conflicts.

1.5.2 Looking to the Future of Joint Ventures

The final chapter reviews the major issues of incentive bargaining in joint ventures by comparing similarities and differences between joint venture agreements and venture capital investment agreements. From the incentive bargaining point of view, joint ventures and venture capital agreements both have characteristics typical of a "contractual organization": a relationship among a relatively small number of contractual parties (investors) that wish to incentivize each other to contribute capital through shared ownership and shareholder agreements. In both types of contractual organization, the parties engage in incentive bargaining over the sharing of total return separate from the sharing of control. They demonstrate, however, distinguishing characteristics as they have been used in completely different ways in practice.

The following are the major characteristics of incentive bargaining in joint ventures which are distinguishable from incentive bargaining in venture capital investments: (1) in joint ventures it is necessary to reconcile the imbalance between monetary capital contributions and human capital contributions; (2) built-in self-dealing transactions, which play an important role in reconciling the imbalance contributions, create conflicts; (3) staged financing schemes are rarely used; (4) the parties rarely intend to exit through an IPO (initial public offering) or M&A (mergers and acquisitions); and (5) the reputational mechanism rarely provides much incentive to refrain from opportunistic behavior.

Interestingly, in recent years, the above-listed distinctions have been blurred, resulting in a hybrid-form contractual organization. This form is most frequently used when large corporations seek to form a relationship with technologically innovative start-up companies. For example, in a strategic alliance of a mega-pharmaceutical company and a biotech start-up company, the mega-pharmaceutical partner often acts as both a VC and a JV partner, and its role evolves as the subject drug development progresses.

Another typical example of a hybrid contractual organization is a strategic alliance between VCs and large corporations acting as strategic investors. Although large manufacturing corporations have historically made direct investments of venture capital on occasion (corporate venture capital), conflicting interests prevent them from creating true synergies. Attempting to ease these conflicts, large corporations have started to form alliances with professional VCs. The characteristics of these alliances place them somewhere in between joint ventures and venture capital agreements. They can be called "joint venture capitals." Some of them are more like joint ventures, and others are more like traditional venture capitals.

In practice, the joint venture is a creature of trial and error. Although there is potential for synergy and the same incentive bargaining problems have been a constant for a long period, adaptations/modifications to incentive bargaining are still being attempted and the characteristics of future joint ventures may differ from what we see today.