Navigating Joint Ventures and Business Alliances

Success factors in executing complex arrangements that are challenging to negotiate, operate, monitor and exit
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Innovative transaction structures are being used more frequently to achieve strategic objectives, realize value and drive growth.
The globalization of business models and dramatic change in the way that businesses operate and compete in today’s economy have resulted in a shift in M&A strategy and execution. Increasingly, corporations and investors are going beyond the traditional acquisition/disposal model, using Joint Ventures (“JVs”) and business alliances to achieve their business development objectives.

Examples of the types of structures being employed include:

- JVs
- Partnerships
- Minority Investments
- Virtual JVs
- Long-term Contracts
- Seller Financings

There are many benefits to using a JV or business alliance structure—namely: entrance into new and geographic markets, new product/development opportunities, cost sharing, mitigation of execution risk, alternate funding sources and divestment of a non-core asset.

That said, the ability to anticipate, manage and monitor the on-going challenges associated with any JV or business alliance is more important than ever. Failure to identify and consider the variety of risks in these arrangements can have a significant impact on the likelihood of success in any JV or business alliance, and on its value to the overall enterprise.

On the following pages, we discuss factors motivating the utilization of JVs and business alliances and the complexity and challenges associated with establishing these vehicles.

We also highlight planning considerations, a critical path associated with successful JVs and business alliances, factors to consider in due diligence and a number of ongoing operational and governance considerations.

We conclude with a detailed discussion of the accounting considerations for the most commonly employed JV and business alliance structures in the market today.
An in-depth discussion

Factors motivating the utilization of JVs and business alliances
In today’s market, JVs and business alliances are becoming more and more prevalent. The transactions being contemplated are complex, difficult to execute, and hard to sustain, whatever their form. Due to the long-term nature of many of these arrangements, managing execution risk on a JV or business alliance is more critical than ever to the success of the overall enterprise.

Despite the complexities, companies have a variety of motives underlying their use of JVs and business alliances.

1. **Entry point for emerging markets**
   The increasing difficulty of achieving a rapid, relevant and meaningful presence in high-growth emerging markets, coupled with escalating execution risk and regulatory/operational issues facing today’s organizations, has led to a dramatic increase in the utilization of JVs and business alliances. These structures are seen as a way to achieve an impactful point of entry into strategically important markets, however, a number of unforeseen challenges often emerge. Finding the “right partner” and establishing mutual trust is the first step, especially when an emerging market is involved. This involves a careful assessment of counterparty risk as well as clarification and understanding of the strategic motives of each of the participants. Another critical step to be addressed pre-signing involves establishing a framework for management appointments, stakeholder monitoring, oversight and exit as it provides stakeholders with the means to redirect or turnaround an alliance that may have strayed from the strategic objectives and to exit if appropriate.

2. **Cost sharing on big-ticket IP development or marketing**
   The ability to share the up-front cash investment for development or exploitation of new intellectual property (“IP”) with a partner(s) via a co-financing arrangement is a common motive for creation of a JV or business alliance. These arrangements are commonly utilized in industries as diverse as aviation, pharmaceuticals, technology, automotive and media. These transactions are typically product or project specific, and as a result they are complex and require significant up-front negotiation and investment of management time to complete.

3. **Mitigation of execution risk**
   Certain JVs and business alliances are motivated by the need to share what are often significant up-front risks in developing new products and/or business models. They can also be utilized as a means to providing access to efficiencies through the sharing of scarce functional expertise or resources – spreading the bet.
4. **Divestment of sub-scale and non-core businesses**

Earnings pressure without top-line growth has put the spotlight on restructuring, cost-cutting and portfolio realignment. Such initiatives are often achieved via JVs or some form of business alliance. More commonly, JVs and business alliances are being utilized as a means of achieving a step divestment of a non-core business or function, or to combine a sub-scale business with a supplier or competitor in order to achieve a desired scale and potential for future profitability that benefits all parties. In addition, these arrangements are being utilized to achieve a divestment where a value gap exists through the retention of a minority interest, or inclusion of seller financing. However, such structures may not provide an immediate or high infusion of cash and they can complicate deconsolidation accounting.

5. **Cash preservation**

Non-monetary exchanges and asset swapping arrangements have been considered across a variety of industries as a way to reweight portfolios and transact in cash-constrained environments. However, it is especially difficult to identify the right partner, arrive at mutually acceptable terms and negotiate values and structure with these types of arrangements.

6. **New sources of funding and opportunities**

A lack of available investment capital or a low appetite for M&A risk is another motive behind JVs and business alliances. Corporations have looked to partner with financiers such as private equity funds, hedge funds and sovereign wealth funds to co-invest in their strategic targets. These arrangements are often extremely complex structures with put and call options and decision triggers that can result in a divergence of ownership interests around factors such as business strategy, the venture’s life-cycle and other exit motives. The partners need to ensure these scenarios are thoroughly evaluated and fully contemplated at the negotiation and implementation stage in the JV or business alliance.

7. **Access to government sponsored projects**

Governments seeking alternate sources of capital or expertise to fund and operate large infrastructure projects or to seed the establishment of local businesses are increasingly willing to enter into JV or business alliance vehicles such as Public Private Partnerships (PPPs) and sovereign wealth fund investments with more established corporations. These relationships also act as a pipeline for established businesses to expand with attractive new business opportunities in emerging markets and technologies.

8. **Accounting and tax rule changes**

In certain cases, accounting and tax rules are the motivating factors for a JV or business alliance. These include potential gain recognition, off-balance sheet financing and pass-through structures that may allow tax gain deferral and accelerate the use of tax attributes.
Complexities and challenges with JVs and business alliances

JVs and business alliances take form through a variety of structures and arrangements and, more often than not, they are being executed through increasingly complicated structures as participants seek to build in flexibility and options that balance the benefits of new opportunities and the resultant upside with a heightened level of risk aversion.

Business alliances being considered today are increasingly complex

The terms and value protections included in these structures - such as puts, calls and collars required by minority investors, sellers, governments and financial sources - introduce new forms of complexity. Often the complexity has unintended consequences which can impact operating decisions, performance and hence the overall success of the arrangement. Consider these three areas:

1. **The degree of trust and mutual understanding between the participants** must be nurtured and managed very carefully. Any void or breakdown of trust and understanding will impact everything from the speed of negotiation to the development and documentation of a strategy and operating plan.

When all parties to a JV or business alliance understand the respective strategic rationale and objectives motivating the alliance, there is a far greater likelihood that the participants will be able to build a sense of mutual trust. This then facilitates the negotiation of the transaction and means there is a greater likelihood the participants will be able to establish a framework for the ongoing monitoring and management of the alliance, benefiting everyone involved.
2. Mechanisms for the regular monitoring of performance are essential, as are governance agreements that set out how and when participants can exert influence over decisions of the JV management team. In many instances the governance mechanisms put in place at the outset of the arrangement lack adequate flexibility or any means to adapt as the business or participant needs change which, if unchecked, can serve to undermine the viability of the JV or business alliance.

JVs and business alliances are a challenge to structure, negotiate and implement, however, they are often most challenging once established and operating. It is at this stage of the life-cycle where the participants need a clearly defined and well understood framework that tracks the business performance, while it also provides a roadmap for any alliance that might suffer from indecision or an inability to achieve consensus.

Actively managing any interest in a JV or business alliance is the key to realizing the transaction’s potential value and long-term strategic objectives. This requires a meaningful level of resources to oversee and monitor performance and execution against the business plan.

Anticipating and identifying future risks to the JV or alliance business model depends upon the level of visibility that the participants have in day-to-day activities. An effective monitoring framework needs to provide transparency into the operating activities such that each participant can understand the business drivers, the economic, operational and financial position and the trading results. In addition, participants need a set of pre-prescribed levers to pull that allow them to insert themselves into the operation, revise the arrangement or the strategic direction and, if necessary, to unwind their involvement at a point in time.

3. Exit triggers available to each of the participants are often poorly defined or misunderstood from the outset of the alliance. Clarity around the circumstances allowing any participant to divest their ownership or interest in the structure, and the related valuation formula, should be negotiated and agreed to by all participants in the formation phase of the JV or business alliance.

A strong sense of trust, robust governance frameworks and ongoing stakeholder communications form the bedrock for successful JVs and business alliances... no matter how complex the structure.
Critical path to success

A well understood strategy underlies each step in the critical path to success for a JV or business alliance. The strategy needs to reflect the input and agreement of each participant and should be clearly and comprehensively documented in the form of a business plan and governance framework that is monitored over the life of the arrangement. The following table sets out the key steps in the path to success and the core considerations which should be addressed at each step.

<table>
<thead>
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<th>Critical path toward success in any JV or business alliance</th>
<th>Specific considerations to address and agree to prior to entering into any JV or business alliance</th>
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<tr>
<td>1. Understand and define the strategy</td>
<td>• What are the strategic objectives of the business alliance?</td>
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<td>• How does this fit with the current business strategy for each participant?</td>
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<td>• How does the JV interact with its shareholders or related parties (market and IP)?</td>
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<td>• What is the life-cycle of the JV or business alliance, and what are the exit triggers for the participants?</td>
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<td>2. Define the governance and risk management protocols</td>
<td>• Has a JV risk-planning organization been defined?</td>
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<td>• How will decisions be made, and what is the dispute-resolution process?</td>
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<td>• How is the management nominated? Compensated?</td>
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<td>• What level of authorization has been designated?</td>
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<td>3. Address communication culture, including the stakeholders</td>
<td>• Who are the key stakeholders in the JV process?</td>
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<td>• How well is the JV or business alliance rationale shared and understood by stakeholders?</td>
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<td>• Which culture of the parent companies will prevail?</td>
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<td>• Do the participants have experience participating in a JV?</td>
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<td>4. Identify the assets, people, resources and IP essential to the success of the business alliance and reach consensus before the initiation date</td>
<td>• What specialist resources, people, technology and assets will be required to deliver the JV benefits?</td>
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<td>• What access to these assets do the JVs parents have?</td>
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<td>• What information is sensitive? What is the proper level of disclosure?</td>
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<td></td>
<td>• How are IP and other assets best shared and protected?</td>
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<td>• How is balance achieved between the ongoing R&amp;D initiative/support of the parents vs. IP developed by the JV?</td>
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<td>5. Document a set of agreed-upon and well-understood organizational and operating assumptions</td>
<td>• Which people, processes, technology, suppliers, policies, etc. will be used in the new JV?</td>
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<td>• How are these transferred to the JV in consideration of their valuation and the related costs arising upon transfer?</td>
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<td>• What are the dependencies and impacts of the JV on the parent organizations?</td>
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<td>• How do JV partners effectively enforce the non-compete arrangement?</td>
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<td>• What is the level of the JVs autonomy?</td>
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<td>6. Set out the financial goals and profit/cost sharing framework</td>
<td>• What are the financial goals?</td>
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<td>• What are the capital and resource requirements and timing?</td>
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<td>• How will profits and costs be shared?</td>
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<td>• Is the compensation plan aligned with the strategy and incentivizing the right behaviors?</td>
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<td>• What is the transfer-pricing mechanism for related-party transactions?</td>
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<td>7. Establish the management and financial reporting requirements and related policies</td>
<td>• What framework and systems are needed for the future financial - and management-reporting requirements?</td>
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<td>• How will partners account for the JV? (Consider US GAAP and local GAAP)</td>
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<td>• What is the level of disclosure to each of the participants?</td>
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<td>• How compatible are the systems across the parent organizations?</td>
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Emerging market nuances

The implementation of a JV or business alliance in an emerging and growth market can be fraught with complex issues. These markets present cultural, regulatory and economic challenges that must be anticipated early. All too often, participants in JVs and business alliances in these markets will be required to exercise considerable judgment and that may mean difficult trade-offs become necessary in order to navigate the conflicting perspectives of key internal stakeholders. There are many nuances in each and every growth and emerging market, so participants should enter into these arrangements with their eyes open. Here are common themes that require careful evaluation:

Sovereign risk—this is a reality

• How will sovereign risk be monitored, and which models will be used to assess, predict and prepare for potential issues?
• Government relations and lobbying must be carefully managed.
• Political and economic stability of each country with sales offices or operating facilities require ongoing assessment.
• The impact of religion may be significant.
• What impact will FCPA, Anti-Money Laundering and similar legislation have on the business model and competitiveness?

Operating considerations are often country specific

• Intellectual property (protection, recourse and compliance reporting)
• Adapting existing products and services to local conditions (price, quality, features, etc.)
• Management control and restrictions on ownership in local markets
• Financing sources for capex, working capital, etc.
• Entry and exit requirements and strategy
• Profit repatriation
• Closed vs. open markets
• Benefits of partnering with local resources
• Security of both physical sites and personnel

Staffing and local market resources demand close attention

• Availability, quality and need for local talent
• Screening, hiring and training practices
• Compensation and benefits necessary to retain key management and employees
• Agreement on expatriate cost sharing arrangements

Local business and legal environment can change very quickly creating operating and investment risk

• Local customers, business practices and labor laws (including hiring and firing restrictions)
• Contractual requirements, documentation norms and requirements
• Import and export, duty and other commercial requirements
• Legal entity structure aligned to available tax benefits
• Structure and extent of bank- and/or financial-entity regulation and supervisory oversight
• Permissibility of activities and/or product-specific or service-specific constraints (e.g., design of products, revenue or fee restrictions)

Care and caution are required as corporate cultures and operating styles can be dramatically different from one emerging market to another - there is not a one-size-fits-all solution.
Due diligence and integration plans

Robust due diligence establishes the foundation

Comprehensive due diligence is essential before entering into any form of relationship. It is imperative that both the contributed and acquired businesses be assessed prior to signing any form of binding agreement.

The key considerations for due diligence and Day 1 planning are outlined below.

**Detailed assessment of partner contribution**
- Revenue drivers and profitability of businesses, key products and customers
- Quality of revenue and earnings
- Forecast sensitivities and basis of key assumptions
- Cash flow drivers and concerns
- Stand-alone cost assessment and level of parent allocations
- Balance sheet exposures and off-balance-sheet contingencies
- Working capital assessment and definitions to minimize post-closing disputes
- Accounting policy basis and consistency
- HR benefits, attributes and assumed/transferred liabilities
- Tax attributes and exposures
- Counterparty considerations (credit risk, funding, culture)
- IT systems and requirements
- Transition services required

**Detailed assessment of the business/asset to be contributed**
- Carve-out considerations
- Assets vs. legal entities
- Co-mingled operations, assets or liabilities
- Normalized earnings
- Gain/loss calculation
- Goodwill allocation
- Stand-alone, stranded and one-time separation costs
- Tax attributes
- HR-related matters (change of control, potential liabilities to transfer)
A detailed integration plan should be established

For any new business alliance, the alignment of the participants prior to close is a critical factor in realizing long-term success for the relationship.

Pre-Close

Partner-contributed assets
- Monitor business/asset performance through close
- Analyze working capital and key valuation triggers

Contributed assets
- Evaluate any up-front gain/loss recognition
- Carve-out business/asset and prepare for Day 1

Other pre-close steps
- Ensure that clear organization and governance structures exist
- Plan for Day 1 and develop the 100-day plan
- Understand and resolve any operational stabilization risks
- Plan how to retain key talent, customers, vendors and partners
- Evaluate Day 1 and ongoing accounting impact
- Assess contingencies arising from the deal and/or acquired with stock contributed to business

Drafting of agreements
- Draft comprehensive documentation of the investment agreement with defined terms and a framework for operating, monitoring and exiting
- Complete the slate of transition service agreements and shared long-term service arrangements
- Capture all due diligence findings in transaction agreements

Post-Close

Execute the 100-day plan and begin longer term planning
- Focus management on the operations of the business by:
  - Executing growth strategies (M&A, new product development, leveraging partner relationships, etc.)
  - Implementing cost-out and restructuring programs
  - Reducing working capital investment and cash cycle
  - Reducing financing costs (i.e. financial engineering)
  - Ensuring reporting functions meet regulatory, company and partner requirements including:
    - Performance assessment and review
    - Treasury and cash management
    - Financial close
    - SOX
- Transition to a combined/integrated IT platform to improve operating efficiency while limiting business disruption
- Establish HR policies, procedures and benefit programs
- Actively manage and protect rights to all IP of the business
- Protect market share and customer relationships during transition

Newly Formed Structure

Due Diligence

- Monitor business/asset performance through close
- Analyze working capital and key valuation triggers

- Evaluate any up-front gain/loss recognition
- Carve-out business/asset and prepare for Day 1

- Ensure that clear organization and governance structures exist
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Governance and operational considerations

A JV or business alliance has to anticipate and plan for a number of operational changes and governance structures that will be new to the business being developed in, or contributed to, the alliance vehicle. These changes and considerations will need to reflect a blend of corporate cultures, while some others may be new to all the participants. A number of these considerations are raised in the following pages.

1. Operations and strategy should be aligned with all stakeholder motives and interests

Given the variety of cultural and operating perspectives that each participant in the alliance brings to bear, the operating strategy and structure negotiations can be difficult.

The long-term vision for the alliance culture, strategy, and goals must be aligned with, or complementary to, each participant’s vision

- Requires agreement on business plans and forecasts (operating and capital) during negotiation phase
- People, transactional processes and technology requirements for the alliance—including participant support—to be determined up front:
  - Sales and marketing approach
  - Procurement and vendor selection
  - Design, manufacturing and distribution
  - Regulatory compliance (quality, IP, industry)
  - Systems and technology
  - HR and other resources, both direct and via TSA’s, SLA’s etc
- Rights of access to licenses, patents and IP

Budgeting, forecasting and performance assessment require a constant focus

- Philosophy around budgeting and planning (e.g., “must-hit” or guidance)
- Timing and business planning cycle

Close attention to the governance structure that provides oversight of the operating environment and protocols is required if the alliance entails joint control

- Operating and management protocols - level of participant support, oversight and integration for start-up and ongoing operations (including contingency plans)
- Selection of alliance leadership - start-up and ongoing, decision making rights, dispute-resolution process, communication and reporting protocols
- Communication protocol for participants, investors, regulators, etc.
- Protecting sensitive information - both operating and financial (whether that of the alliance or its participants)
- Country-specific laws and regulation

- Key metrics tracked/KPIs - strategic, operating and financial
- Short term cash forecasting
- Alignment of incentives with goals
2. Risk and compliance policies and minimum standards should be clearly defined before signing

Aligning the compliance culture and appetite for risk of each participant must be carefully considered and vetted early in the process of establishing the stand-alone policies for the JV or business alliance.

Regulatory requirements

- How will you identify, manage compliance with, monitor and implement changes in requirements?
- Which regulatory bodies and laws apply at the local, state, federal and international level?
  - Foreign Corrupt Practices Act
  - Industry practices
  - Government treaties
  - Anti-Money Laundering
  - Export controls
  - United Nations
  - Office of Foreign Assets Control
- Recognize the importance of governance – key to a successful long-term alliance (e.g., effective board and senior-management oversight and firm-wide risk management programs).
- Based upon market and regulatory standards, what are the appropriate and required levels of capital?
- Recognize that outreach and communication with regulatory authorities will be key to establishing, developing and maintaining strong relationships.

Risk-management function

- Key risks to consider and monitor include:
  - Strategic risk
  - Liquidity/funding risk
  - Credit and counterparty risk
  - Operational risk
  - Compliance risk
  - Reputation risk
- How will specific risk-assessment models be utilized for the business (e.g., counterparty, market, exposure levels)?
- What are the operating implications and potential ramifications for alliance partners?
- Is a strong disaster-planning and recovery strategy/capability in place?

Understanding counterparty risk is key when assessing potential transactions.

- Due to potential problems that may arise in the future, understanding your partner’s contributions to the JV/business alliance and their financial viability is vital in today’s market. Critical matters to understand include:
  - Contributed assets and value going forward
  - Cultural and operational perspectives—e.g., will the relationship be complementary or combative?
  - Counterparty credit risk and its impact on securing adequate sources of liquidity

Insurance requirements

- What will be the insurance needs of the new business and how will existing relationships be leveraged to reduce costs?
Controllership must be actively involved in business alliances. This is especially crucial given the unique structures and lack of direct reporting and internal control oversight.

Establishing accounting policies and controls, and reaching agreement with alliance counterparties on consistent application, are both critical to adequately protecting one’s investment.

- Key accounting policies should be aligned with respective US GAAP or international requirements.
- Alliance vehicles should have a control environment that enables compliance with Sarbanes Oxley and other regulatory requirements.
- Alliance participant requirements and costs of incremental compliance demands need to be understood.
- Where alliance activities are new, accounting policies and procedures should be evaluated and modified as required.
- Continual compliance monitoring is necessary including, but not limited to, independent annual audits.

Due to differing regulatory, compliance and market-specific reporting requirements, the reporting needs of the alliance participants may vary.

- Period-end close timing and other requirements should be aligned.
- Compatible financial systems and counterparty requirements (GL, reporting, AP, fixed asset, AR, etc.) should be established.
- Creating, mapping and updating the chart of accounts for the structure may impact alliance participants.
- Chargebacks for services performed - by either participant or by the alliance itself - must be priced, monitored and tracked for timely settlement.

Governance and guidelines on decision making around financial reporting should be clarified.

- Operational processes should be established to ensure transparency around decision making on critical matters such as budgets, financial leverage, compensation and hiring/firing of management.
- Since operational reporting requirements may vary, they should be established and agreed with each participant.
- Where NewCo structures are employed—and depending upon size/structure—external auditors and/or an internal audit function may be required.
- Governance over communication protocols that enable alliance participants to receive the same information at the same time should be established.
- Appropriate financial reporting and controls resources (transaction processing, specialists, decision support) should be identified and sourced locally or by alliance investor contribution.
4. The tax structure must consider each stakeholder—from formation throughout the life of the vehicle

There are several key tax-planning factors to consider when executing business alliances.

**Develop a structure that meets the following primary goals:**

- Does not involve substantial immediate tax costs as a result of the transaction
- Achieves a tax-efficient flow of earnings on an ongoing basis
- Limits potential taxes upon termination/exit

**Choice of entity for the alliance (partnership versus corporation) will impact tax exposures upon:**

- Creation/formation
  - How the transfers (of tangible and intangible property and services) to the alliance vehicle will be taxed to the transferors
  - Whether the structure triggers transfer/stamp taxes
  - Valuation of assets/liabilities for tax purposes
- Ongoing basis
  - How profits from operations will be taxed to the alliance vehicle and/or owners
  - How distributions of profits will be taxed to the owners
- Divestiture/termination/exit
  - How unwinding or liquidating the JV vehicle will be taxed to owners
  - How the exit (i.e., sale of interest) will be taxed at both the counterparty and alliance levels
  - How partial sale of an interest can lead to loss of tax benefits such as tax consolidation

**Choice of jurisdiction is key when considering structure and counterparty choices:**

- The goal is to lower the global tax rate on income and non-income taxes and withholding rates
- Hybrid entities (e.g., partnership for US tax purposes and corporation for foreign tax purposes) may also be considered
- A number of other considerations when identifying an appropriate jurisdiction include:
  - CFC regimes for deferral of taxation on earnings in low taxed jurisdictions and ability to “base erode” tax of holding company jurisdiction
  - Bilateral tax treaties that impact profit repatriation and remittances and exit strategies (e.g., non-resident capital gains tax)
  - Fx controls/restrictions and regulatory hurdles that cause trapped cash issues (especially relevant in emerging markets)
  - Transfer pricing with regard to contractual arrangements to avoid US and foreign tax authorities from reallocating income
  - Placement of debt to reduce the possibility of interest disallowance in various jurisdictions
  - Tax rules and regulations that continue to evolve, driven by government spending deficits, changing political environments, the high level of employment, etc.
5. Compensation plans and the application of HR policy can make or break any alliance

Given the likely differences between the JV/alliance HR environment and that employed by the participants, on top of the changes in market expectations and regulations around compensation practices, HR needs can be extremely difficult to manage in business alliances.

To be competitive in the local market—yet consistent with counterparty principles—management compensation plans require detailed attention.

- There is growing international consensus on principles that are important for multiple constituents (e.g. investors, regulators, etc.) to understand in terms of assessing the structure of compensation programs vs. risk and compliance considerations. The most common principles to be addressed include:
  - How will fixed and variable compensation be determined?
  - What vesting timeline will apply to incentive compensation awards?
  - Will stock options and other deferred compensation plans be utilized to supplement cash compensation? Which stock will be utilized?

Benefits—including pensions, medical, etc.

- Agreeing on a pension funding policy (minimum contributions vs. stable yearly amount) can be difficult given the potential for differing perspectives and regulatory requirements.
- Benefit plan oversight will be necessary to avoid funding requirement surprises.
- Leveraging the participant’s scale when pricing the alliance benefit plans is an important tool in managing program costs.
- Depending upon the ownership structure, counterparties may be required to reflect alliance employees in their IRS Controlled Group. Typically, this is necessary only when one participant has more than 80% ownership.

HR policies, procedures and governance.

- A governance structure around potentially significant HR spend or commitments should be established and clearly defined.
- The cultural impact of combined resources (including cross-border considerations) should not be underestimated.
- Current immigration restrictions may impact both the quality and availability of resources.
- Other HR policies and procedures to consider include:
  - Severance
  - Employee retention and change in control
  - Trade unions and collective bargaining agreements
  - Any required board representation
6. Treasury policy must contemplate various funding scenarios

Key treasury needs should be identified and agreed up front, along with provisions for contingency funding plans where outcomes differ from day one expectations.

Funding and investing priorities
- Long- and short-term funding requirements
- Guarantees and related accounting impact on alliance participants’ financial reporting
- Timing and processes
- Intercompany cash management, settlement and controls
- Priorities for excess cash and distributions

Risk management culture needs to be established
- The articulation of an enterprise risk-management appetite and philosophy for the alliance
- Establishment of policies that achieve alignment with the expectations and requirements of each of the participants
- Anticipation and incorporation of currency, commodity and other hedging considerations in the risk management protocols of the alliance

Reporting and monitoring considerations
- Policies and procedures, authorization limits
- Systems and monitoring tools
- Customer/vendor credit assessment
- Reporting requirements
- Ongoing external and internal communications
- Tax, TSA and SLA reporting, and compliance
Structures commonly utilized to effect a business alliance

A variety of structures are available to anyone looking to initiate a JV or business alliance, with options including both contractual and structural arrangements. Each have distinct characteristics and features that need to be evaluated and assessed to ensure the most appropriate structure is employed.

Structural Alliances

Joint Ventures
Structure in which two or more parties contribute assets to a legal entity (“NewCo”) and share in the profits and losses.

Limited Partnerships and LLCs
Structure in which two or more partners contribute assets to a NewCo and share in the profits and losses using a pass-through structure for tax purposes.

Minority Equity Investments
Structure in which the investor contributes funds, IP, or other property to an existing entity or target and takes back a minority equity stake.

Contractual Alliances

Virtual JVs
A collaborative arrangement formed via a contractual agreement through which the parties manage governance and oversight and risks and rewards.

Long-term Contracts
An arrangement for a specific task (purchase or supply) that can also be used by the parties to allocate risks and rewards.

Seller Financing
An arrangement where a seller provides financing to the buyer for a portion of the purchase price in exchange for a promissory note from the buyer.
**Joint Ventures**

**Characteristics and common features**

**Description**

A corporate structure in which two or more parties create a separate company by jointly funding it and managing it while sharing in its profits and losses.

**Typical industries**

- All industries

**Potential features**

- Disproportionate economics and/or vote
- Long-term contracts with investors and cooperative agreements
- Redemption rights
- Transfer restrictions on equity
- Shotgun (buy/sell) clause, put and/or calls or rights of first refusal
- Licensing agreement allowing both companies to use the technology developed, IPO or spin-off/sale

**Potential benefits**

- Enables investors to share risks, rewards and talents in developing a new market, product or technology
- Enables investors to combine complementary technical knowledge or to pool resources in developing production or other facilities
- Can be a prelude to a larger deal or similar deals in other regions/markets
- Transfers of property to corporation can be structured to avoid taxable gain to transferors
- Combination of two businesses may allow for the accelerated use of tax attributes (e.g., the losses of one business may be offset against the income of the other business to reduce combined taxes)

**Potential challenges**

- Complex to negotiate and structure—including business plan, operating structure, governance, plan for dissolving, service level agreement, cost sharing, etc.
- Requires ongoing negotiations to manage and leverage JV activities
- Risk to investor’s reputation due to lack of control/oversight over partner
- Limited useful life
- Parties should agree upfront how “contributed” tax attributes affect pricing (e.g., whether one should pay for tax attributes such as high-basis depreciable assets contributed by the counterparty).
- Corporate tax upon liquidation/exit

**Accounting and financial reporting**

- Partial or full gain recognition may result upon contributing appreciated assets/business/subsidiary to the JV.
- Consolidation assessment can be challenging with near 50-50 deals, non-equity investor contracts or financings, related party relationships, puts and calls and/or transfer restrictions among the participants.
- If not consolidated, consider equity-method versus cost-method (or mark-to-market) accounting for the investment.
- Puts and calls, considered derivatives, may need to be marked to market through earnings each period.
- JV accounting applies only when there is true joint control.
**Limited partnerships and LLCs**

Characteristics and common features

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<tr>
<th>Description</th>
<th>Structure in which two or more partners contribute assets to a NewCo and share in the profits and losses using a pass-through structure for tax purposes</th>
</tr>
</thead>
</table>
| Typical industries | • Alternative Investment Management (private equity firms, hedge funds)  
• Real Estate  
• All other industries |
| Potential features | • Disproportionate economics and/or vote  
• Long-term contracts with investors and/or cooperative agreements  
• Redemption rights  
• Transfer restrictions on equity  
• Shotgun (buy/sell) clause, puts and/or calls or right of first refusal  
• Kick-out rights for LPs (to dissolve the partnership and/or remove/replace the GP)  
• Participating rights for the LPs  
• Incentive distribution rights ("carried interest") for the GP  
• Licensing agreement allowing both companies to use the technology developed, IPO, or spin off/sale |
| Potential benefits | • Favorable tax treatment on profits earned  
• Reduced regulatory burden  
• Can decrease liability assumed  
• Can be structured to avoid taxable gain to transferors upon formation  
• Any tax losses can flow through to its partners  
• Can be liquidated on a tax-deferred basis (as opposed to corporate structures)  
• Flexibility in allocating items of income and losses to the partners  
• Step-up in basis in the partnership’s assets which can be passed on to future buyers upon exit |
| Potential challenges | • Limits investor’s share of income on a profitable venture  
• Limited control (unless you are the GP)  
• GP usually obtains and retains majority of liability risk  
• Potential future tax-law changes to tax carried interest at ordinary tax rates rather than at capital-gains tax rate  
• Complexity of partnership agreements for special allocations of income and losses  
• Additional compliance burden for partnership tax returns |
| Accounting and financial reporting | • Partial or full gain recognition may be achieved upon contributing appreciated assets/business/subsidiary to the partnership.  
• GP is generally presumed to control (and thus consolidate), but it may not control if it can be unilaterally exercised by a single party.  
• As the LP gains more control over the partnership and/or exposure to risk of losses increases, the risk of consolidation by the LP increases.  
• Puts and calls, considered derivatives, may need to be marked to market through earnings each period. |
Minority equity investments
Characteristics and common features

**Description**
Investor contributes funds, IP, or other property to a target and takes back a minority equity stake

**Typical industries**
- Pharmaceutical and other industries

**Potential features**
- Upside potential—can be locked in by the minority investor via puts/calls, distribution arrangements or other contracts
- Minority investor—may get board representation or a role as technical advisor

**Potential benefits**
- Early investment in a new product or technology buys access and bars competitor access
- Opportunity to observe/evaluate management team with limited downside
- Transfers of property to the target—likely to trigger taxable gain to the minority investor/transferee, but, if properly structured, can be transferred on a tax-deferred basis with the cooperation of the counterparty (the other shareholders)

**Potential challenges**
- Access to upside—may be necessarily limited due to consolidation risk
- Limited control/influence over operations and milestones without majority investment or contractual rights

**Accounting and financial reporting**
- Partial or full gain recognition may be achieved upon contributing appreciated assets/business/subsidiary to the venture.
- As an investor gains more control over the venture, or is exposed to more of the risks of losses, or has rights to receive benefits related to the entity, the risk of consolidation increases—dependent upon which consolidation model applies.
- If not consolidated, the investor would treat this as an equity-method investment if it can exert significant influence on the venture. Otherwise, the cost-method or a mark-to-market security would be appropriate.
- Puts and/or calls, considered derivatives, may need to be marked to market through earnings.
**Virtual Joint Ventures**

**Characteristics and common features**

**Description**
Collaborative arrangements that are formed via contractual arrangements to manage governance and oversight and to provide a mechanism for risk and reward allocations.

**Typical industries**
- Pharmaceutical industry
- Biotechnology industry
- Motion Picture industry
- Technology industry
- Manufacturing industry

**Potential features**
- Each party able to maintain contractual rights to underlying IP
- Payments between parties typically structured based on milestones (specified time or event), time and materials and/or royalties/profit sharing on eventual product sales
- Possible to arrange direct loans, guarantees or equity investments in the partner

**Potential benefits**
- Means of avoiding complexity and tax impacts associated with negotiation, formation and unwinding of a legal structure
- Reduces or eliminates need to capitalize up front
- Accelerates time to market
- Frees each company to focus on core competencies
- Provides access to broader range of resources, technologies and capabilities

**Potential challenges**
- Reduced ability to monitor and oversee partner activities as compared to a JV
- Risk of IP and data-security breaches
- Puts investor’s reputation at risk due to lack of control/oversight over partner

**Accounting and financial reporting**
- Collaborative arrangements not involving a legal entity are generally outside the scope of the consolidation/equity method accounting guidance.
- Investors report their share of income and expenses in accordance with the substance of the transactions.
- No gains would be recognized for the “contribution” of appreciated assets to the virtual entity.
- Interests in the partner, even if only a guarantee of its debt, may need to be evaluated for consolidation.
## Long-term contracts
### Characteristics and common features

<table>
<thead>
<tr>
<th>Description</th>
<th>Long-term contracts allow one company to partner with another, often solely for a specific task over specified term</th>
</tr>
</thead>
</table>
| **Typical industries** | **• Automotive industry**  
**• Aerospace and Defense industry**  
**• Manufacturing, Technology and Construction industries** |
| **Potential features** | **• Pay-to-play provisions**  
**• Options to acquire rights to the results of R&D activities**  
**• Liquidated damages clauses/termination provisions**  
**• Price adjustments based on volume, increased costs, cost-plus and related measurement, changes in market prices or other factors** |
| **Potential benefits** | **• Locked-in pricing and/or quantity or built-in price adjustment features enabled**  
**• Transferring uncertainty and risk to others, particularly for R&D activities, sometimes enabled**  
**• Commoditized functions or functions not within company’s core competency outsourced**  
**• Possibility of enhanced ability to obtain long-term financing**  
**• Management free to focus more on production and less on marketing/supply chain management**  
**• Limited tax deferral for deferred revenue possible (i.e., advance payments received before economic performance; deferral for one taxable year available)**  
**• Income from certain long-term contracts (those involving building, installation, construction, or manufacturing) can be reported under the percentage-of-completion method for tax purposes. Net profit on the entire contract, in very limited circumstances, may be reported under the completed-contract method in the year in which the contract is completed and accepted** |
| **Potential challenges** | **• Possibility of buyers being locked into a contract that may no longer be economical (i.e., price received does not adjust based on changing market conditions)**  
**• Reduced market flexibility**  
**• Penalties for non-delivery or not taking can restrict ability to respond to market demand** |
| **Accounting and financial reporting** | **• Manufacturers may be able to capitalize pre-production costs.**  
**• Pay-to-play payments may be capitalized rather than expensed; pay-to-play receipts are generally deferred.**  
**• Long-term construction contracts are recognized on a completed-contract or percentage-of-completion basis.**  
**• Long-term contracts may expose the buyer to risks and rewards related to the counterparty, and increase consolidation risk.**  
**• R&D funding received from another party may need to be recorded as a liability.**  
**• Supply/purchase agreements may be deemed to contain a lease, which could result in a capital lease obligation on the purchaser’s balance sheet.**  
**• Generally, losses on executory contracts (purchaser or supplier) are not recorded unless specifically required by GAAP.** |
**Seller financing**

Characteristics and common features

<table>
<thead>
<tr>
<th>Description</th>
<th>Seller provides financing to the buyer for a portion of the purchase price in exchange for a promissory note from the buyer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Typical industries</td>
<td>• All industry groups in current market</td>
</tr>
</tbody>
</table>
| Potential features | • Interest rate typically at or below bank prime rates  
• Term of the seller note usually similar to that of a bank |
| Potential benefits | • Seller may be in a stronger position to receive a higher sale price and/or close the deal faster  
• May act like a bond for performance to assure that seller will live up to promises made to the buyer during sales process  
• May be seen by buyer as indication that seller has faith in the future of the business  
• Motivates seller to maintain the business goodwill if they have a remaining stake in its future ability to pay back the seller note  
• Attracts more buyers who may not be able to receive financing from traditional lenders  
• Size of business may make cash sale difficult for the buyer  
• If seller is to receive deferred payments on the sale of property, then gain may be reported using the “installment-sale method” where gain is pro-rated and recognized over the period in which payments are received  
• If carefully structured as an “open transaction,” where total purchase price is contingent, up-front tax could be avoided |
| Potential challenges | • Risk that seller may act like a bank, asking buyer to secure the loan and sign a personal guaranty  
• Shifts more risk to the seller, which may impact the consolidation and/or gain-recognition analysis  
• Risk that seller might not recover full purchase price if the business fails  
• Likelihood that seller will need to pay tax up front on any gain inherent in the assets sold even though there are no cash proceeds on the sale; limited exceptions apply (e.g., installment sale, open transaction) |
| Accounting and financial reporting | • Seller financing may be considered a form of continuing involvement with the entity that may preclude deconsolidation and gain recognition.  
• Seller financing may significantly impact the consolidation analysis, shifting more risk of consolidation to the seller. |
### Determine the best structure

The structure employed for any JV or business alliance should be closely aligned with the underlying business objective of the participants. The table below sets out a number of typical business objectives motivating a JV or business alliance and the structures most commonly employed to achieve those objectives.

<table>
<thead>
<tr>
<th>Structure</th>
<th>Description</th>
<th>Key Terms</th>
<th>Industries Used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint Development Arrangements (JDAs)</td>
<td>Structure utilized when up-front R&amp;D costs are significant and the viability risk is too great to be borne solely by the developer</td>
<td>No legal entities formed. Payments to developer typically cover over 50% of total project-development costs and may be up-front or phased, depending upon agreement. Contributors receive a license agreement or other benefit.</td>
<td>Technology, Manufacturing</td>
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<td>Co-op Type Arrangement</td>
<td>Multiple parties in an industry join together and form a co-op arrangement</td>
<td>Separate legal entities and financials are established with parties contributing different assets (IP, cash, people, etc.). Co-op members share in profits/losses and in any new IP developed by the co-op.</td>
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<td>Distribution Agreements</td>
<td>Typically structured where developer transfers distribution rights to a partner who receives a fee</td>
<td>No legal entities are created, however, separate financials or performance tracking is required. Compensation to the distributor varies, but typically includes them paying up-front sales and marketing costs (or P&amp;A), with cost recovery based upon sales.</td>
<td>Media, Pharmaceuticals</td>
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<td>Local Marketing Agreements</td>
<td>Agreement in which small industry participants pay larger company to perform certain services (typically sales)</td>
<td>The contract specifies commissions, resources to be deployed, IP protections and non-compete arrangements. Benefits include reduced costs for both companies and improved sales for the smaller company.</td>
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<tr>
<td>Public Joint-Development Company</td>
<td>Similar to co-op, structure involves creating an R&amp;D company and taking it public to raise funding for high-cost next generation technology development</td>
<td>Separate legal entities and financials are established. Equity held by each contributor would be limited (i.e., significantly less than 50%), with funding coming from the public offering. Contributed assets may include people, IP, fixed assets and cash. This relatively new vehicle is highly complex in its structuring and deal execution.</td>
<td>Technology</td>
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<td>Sovereign Wealth Fund Investments</td>
<td>Can take the form of formal JVs or more informal equity investments (banks) or via partnership/funding arrangements. May provide access to “closed” markets.</td>
<td>Financial terms vary by investment, but due to political concerns, SWFs typically prefer non-controlling stakes. As of yet, they have not requested IP ownership or transfers. There may also be a social agenda (access to markets and IP) associated with their investment in emerging markets such as China.</td>
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<td>Hedge-Fund Financing</td>
<td>Structures can vary but typically take the form of hedge funds financing up-front costs and taking a share of profits in the future.</td>
<td>No separate legal entities are created, but profitability/revenue tracking is required. Hedge funds are creative and will pursue most strategies and structures if returns exist.</td>
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**Accounting considerations**

There are some basic building blocks for accounting considerations for JVs and business alliances. The characteristics of each business alliance structure should be carefully evaluated, as the structure will impact the accounting, operations and economics of the deal.

The following table outlines the typical accounting matters associated with these structures.

<table>
<thead>
<tr>
<th>Key accounting matters</th>
<th>Description</th>
</tr>
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</table>
| **Consolidation**      | - **Voting control.** Investor with voting control generally consolidates.  
                       |   - Minority investors with participating and/or significant veto rights may preclude consolidation by the majority investor.  
                       |   - Only substantial kick-out rights and participating rights that can be unilaterally exercised by a single party should be considered in determining who is the primary beneficiary.  
                       |   - **Variable interest entity ("VIE").** Investor with a variable interest in a VIE must qualitatively assess whether it has a controlling financial interest in the entity and, if so, whether it is the primary beneficiary based on whether the investor has the following two characteristics:  
                       |   |   - The power to direct activities of the VIE that most significantly impact the VIE economic performance  
                       |   |   - Obligation to absorb losses from, or right to receive benefits of, the VIE that could be significant to the VIE  
                       |   - Consider cost, equity method and/or mark to market treatment for unconsolidated investments. |
| **Gain recognition**   | - **Deconsolidation of a controlled (substantive) subsidiary** generally results in full gain recognition.  
                       |   - Appropriateness of full or partial gain treatment is subject to uncertainty when contributing a business that is not in a subsidiary.  
                       |   - Continuing involvement may preclude divestiture treatment.  
                       |   - **Consider non-monetary exchanges.**  
                       |   |   - Full gain recognition is generally appropriate when exchanging appreciated assets for a cost method investment.  
                       |   |   - Partial gain recognition is generally appropriate when exchanging appreciated assets for an equity-method investment.  
                       |   - **Seller financing** can be a form of continuing involvement with the entity that would preclude divestiture recognition and any potential gain that may be associated with the transaction. |
| **Derivatives**        | - Formula pricing in long-term contracts may contain embedded derivatives requiring separate mark-to-market accounting.  
                       |   - Puts/calls on equity may be derivatives requiring mark-to-market accounting.  
<pre><code>                   |   - Consider classification of financial instruments in the capital structure (i.e., liability, equity, or mezzanine equity) and evaluate for embedded derivatives that may require bifurcation and mark-to-market accounting. |
</code></pre>
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| **Embedded leases**    | • Arrangements not structured as leases may be deemed to contain a lease.  
| Identifying the population of leases | • If a purchaser has the “right to use” specific property, plant or equipment, then both the purchaser and the supplier would perform lease-classification tests.  
|                        | • Common in power-purchase agreements and purchase/supply agreements. |
| **Revenue recognition**| • In long-term construction contracts, evaluate whether percentage-of-completion or completed-contract method is appropriate.  
| Identification and treatment | • Consider a revenue-recognition pattern for fees received up front.  
|                        | • In collaboration arrangements, consider gross versus net reporting and classification of income and expenses.  
|                        | • Funding received for research and development expenses may require liability treatment. |
| **Deferred expenses**   | • Consider whether up-front costs should be capitalized and amortized and, if so, determine the amortization period.  
| Treatment              | • Consider whether losses on executory contracts should be recognized. |
What this means for your business

Align your strategy with your structure.
The level of commitment and complexity associated with any JV or business alliance cannot be underestimated.

Beginning with the structuring and negotiation phase, there needs to be a well-understood vision and purpose that aligns the objectives of all stakeholders and is reflected in a clearly documented strategy.

The participants should each commit appropriate resources and leadership to the execution and ongoing management of the business and establish a sense of accountability for mutual success.

The negotiated agreement should incorporate a comprehensive operating and governance framework for the management and participants in the business alliance. This should set out the policies and procedures to be adhered to by the business, a transparent reporting and communication channel to facilitate ongoing monitoring by the participants and an appropriate dispute-resolution mechanism.

The structure used to effect the business alliance should reflect the overarching business objectives of the arrangement and anticipate an exit by one or all parties at any point in the life of the business alliance.
Acknowledgments

For a deeper discussion on JVs and business alliance considerations, please contact one of the contacts below or your local PwC partner.

Authors

Nigel Smith
Principal, Deals
(646) 471 2651
nigel.smith@us.pwc.com

Donna Coallier
Partner, Valuation Services
(646) 471 8760
donna.coallier@us.pwc.com

John Klee
Partner, Advisory Services
(646) 471 2828
john.klee@us.pwc.com

Christopher Rhodes
Partner, Deals
(646) 471 5860
chris.rhodes@us.pwc.com

Martyn Curragh
Principal, Deals
US Practice Leader
(646) 471 2622
martyn.curragh@us.pwc.com

Jim Smith
Principal, M&A Advisory Services
US Practice Leader
(646) 471 5720
jim.smith@us.pwc.com

Henri Leveque
Partner, Deals
Capital Markets and Accounting
Advisory Services US Practice Leader
(678) 419 3100
henri.leveque@us.pwc.com

Rick Mancuso
Partner, M&A Tax Services
(646) 471 5010
riccardo.mancuso@us.pwc.com
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