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CENTER FOR GOVERNANCE

JOINT VENTURE GOVERNANCE

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INTRODUCTION

Joint ventures (JVs) are booming. Despite operational complexities, they are more important than ever to drive top-line growth and access complementary assets and capabilities. While JVs can enable new growth and some have been very successful, they can also significantly increase investor risk-exposure. Over 90% of JVs Boards and CEOs view JVs as more important than ever, yet low performing, while almost 50% consider them as weak. JVs remain at the center of corporate scandals and their governance is generally sub-optimal. On average, they have less than 50% of basic governance practices in place and represent quite complex forms of collaboration. Good governance matters to JVs and well-functioning JVs matter to companies and their shareholders. Performance and risk oversight are hard enough for any Board.

When oversight duties are shared with other companies, governance can feel like an impossible conundrum. How can Boards improve JV governance and protect shareholder rights while capitalizing on growth and innovation opportunities?

THE LANDSCAPE OF JV GOVERNANCE

A “joint venture” (JV) is a business arrangement with two or more parties forming a jointly owned legal entity to carry out certain business activities. For many companies, JVs are part of the equation to steer the business through periods of economic growth as well as downturns and recovery. Examples abound: Amazon, Aramco, GIC (Singapore’s Investment Corporation), GlaxoSmithKline, Noventiq, PIF (Saudi Arabia’s Public Investment Fund), SABIC, Shell, Siemes, Volkswagen have significant JVs; General Motors entered more than 10 joint ventures since 2022; Intel recently secured $11bn from private equity group Apollo Global to finance a JV chip-factory in Ireland; Disney, Warner and Fox have announced plans for a sport streaming joint venture to reach a wider audience and share the costs of expensive sport rights; Saudi Arabia’s PIF and Pirelli have forged a JV to establish manufacturing facilities in the Kingdom; PIF- owned SITE (Saudi Information Technology Company) invested in a JV with South Korea’s AhnLab Inc. to develop innovation capabilities in Saudi Arabia.[1]

Globally, over the past two years, the number of JVs has doubled and in Saudi Arabia, during 2015 to 2021, JVs have increased by 120% (an average of 138 new JVs per year). For all the frenzy, are JVs success- full? The answer isn’t straightforward, as is the definition of “JV success”. Success is generally viewed in terms of achieving investors’ strategic, financial and operational objectives, yet 50% of all JVs fail on at least one of these objectives. Nonetheless, they remain attractive and promise clear benefits. JVs can enable significant positive contributions to growth, innovation and market access. They can reduce exposure via risk-sharing, be a platform for growth through flexible operating models, can minimize upfront cash investments, offer optionality of exit scenarios and can represent a good.

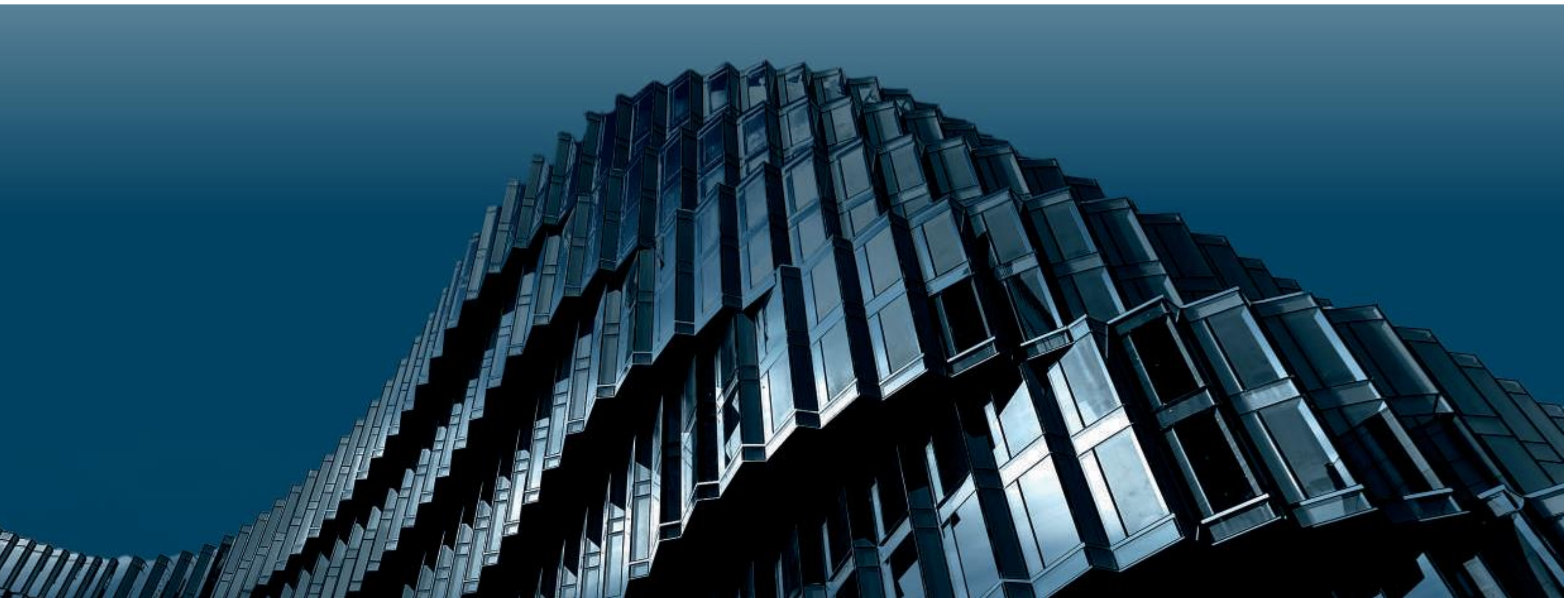
Partnership test before considering full ownership. Despite these benefits, JVs can be complex to set up, manage and govern. Questions of control and operational responsibility can be difficult to resolve and partner relationships are often poor.

JVs pose significant governance challenges and their governance is considered sub-optimal. On average, JVs have less than 50% of basic governance practices in place. Although good JV governance significantly correlates to medium-to-long term financial performance. JVs are at the center of many governance scandals and mis-steps, such as antitrust violations, bribery, human rights violations,

[1]Harvard Business Review (2021). Research: Joint Ventures that Keep Evolving Perform Better. April 12th. Available at: www.hbr.org. Ankura (2022). Saudi Arabia:The Shifting Sands of Partnerships. January. Available at: www.ankura.com.
Bamford et al. (2021). 10 Reasons Joint Ventures Fail. Governance & Restructuring. November. Ankura. Available at: www.ankura.com; PwC (2014).
The Science of Alliances. Success Factors in Joint Ventures and Strategic Alliances. Available at: https://www.pwchk.com; Reuer (2000). Parent Firms Across International Joint Venture Life-Cycle Stages, Journal of International Business Studies 31 (March);Yan & Gray (1994). Bargaining Power, Management
Control and Performance in United States-China Joint Ventures: A Comparative Case Study, Academy of Management Journal 37(6).

environmental and social incidents, safety and data breaches. Examples include the Deepwater Horizon oil spill in the Gulf of Mexico (in which BP co-owned the oil well with non-operating partners Anadarko and Mitsui); New Zealand-based dairy giant Fonterra's JV with a Chinese majority partner and contaminated milk that caused deaths and thousands of illnesses; a series of data leaks at the $20bn internet JV between SoftBank (Japan) and Never (South Korea) leading to significant personal data exposure; Brazilian Samarco's (a JV between mining groups Vale and BHP) and the Mariana dam disaster that caused significant environmental damage, due to the JV's push to cut costs.

Why does JV governance often fail? Several factors account for this state of affairs: misalignment on strategic objectives and priorities; often poor partner relationships (a fertile terrain for misalignment to turn into formal disputes or deadlocks); governance framework (concepts and best practices often do not translate into a JV context, making it difficult to only rely on traditional corporate governance frameworks and tools to improve JV governance); director engagement (directors do not apply the same level of time or attention to JV governance); lack of JV Board resources (Boards often lack sufficient resources to intro- duce and sustain a much needed focus on governance).[2]



[2] Buchel (2003). Managing Partner Relations in Joint Ventures. July 15th. MITSloan Management Review. Available at: www.sloanreview.mit.edu.
Boston Consulting Group (2024). Capturing the Value of JV Governance. Available at: www.bcg.com; Bamford & Walker (2022). Closing the Governance Gap in Joint Ventures. Fall Issue. MITSloan Management Review. Available at: www.sloanreview.mit.edu.
Bamford et al. (2020). Joint venture Governance Index: Calibrating the Strength of Governance in Joint Ventures. Harvard Law School Forum on Corporate Governance. March 13th. Available at: www.corpgov.law.harvard.edu; Bamford & Walker (2022). Closing the Governance Gap in Joint Ventures. Fall Issue. MITSloan Management Review. Available at: www.sloanreview.mit.edu.

CHALLENGES OF JV GOVERNANCE

Regulatory and public pressure on investors and boards of directors to improve governance seems to have left JVs unattended. Regulation imposes significant requirements on the governance of public companies, while national and international organizations recommend an array of best practices: so why isn't JV governance under the same spotlight? Let's review the key challenges of JV governance.

3.1 Ownership Type

JV ownership structure typically includes 2-4 shareholders with their own strategic objectives beyond maximizing returns. JV investors expect the general business direction to serve their own objectives. Most common strategic rationales for JV set up include market access (for instance, building capabilities and learning, or gaining a foothold in a market). Investors' agendas, as well as their risk and investment appetites, can change over time, creating misalignment. Beyond performance and risk oversight, JV governance is essentially about the art of building bridges to avoid divergence of interests.

To make things more complicated, JVs increasingly feature non-traditional partners, such as ambitious and/or venture-backed start-ups or scale-ups, industry disruptors or state-owned companies in unstable and less developed countries, adding an additional layer of instability to the JV.[3]

3.2 OWNERSHIP STRUCTURE

JVs come in different shareholding forms and structures. Many are structured as separate legal entities (also known as incorporated JVs), others lack a separate legal entity, and operate as unincorporated

[3] Bamford, Drutowski, Fernandes, Litewka & Branding Pyle (2022). Misalignment Management in Joint Ventures: Drafting JV Agreements to Prevent, De- escalate, and Resolve Disputes. Negotiation Journal, Fall. Available at: www.direct.MIT.edu

JVs. In the latter, partners use legal and commercial contracts to co-own assets and typically contract one of the partners to operate the assets on behalf of the JV. Different shareholding forms translate into differences in how governance works. For instance, in an incorporated JV, a Board composed of directors with certain fiduciary duties to the partners oversees the entity. Unincorporated JVs do not have a "formal" Board and often use a steering committee to align partner interests and make decisions. Steering committee members do not usually have fiduciary duties to the JV entity. Additional shareholding forms reflect the level of ownership and control JV partners intend to have. Most companies would rather be the majority partner, as this structure is expected to translate into greater control and effective decision-making. Nonetheless, being a minority partner can be beneficial: it can reduce operating responsibility, resource demands and capital payouts; it can lower risk exposure, and keep the JV off the company's consolidated financial statements.

A third ownership structure option is an equal equity split also known as 50:50 JVs. This structure reflects the partners' intent to make similar contributions to the venture (cash and in-kind) upon formation, over time (JV scope alterations) or as a function of regulatory requirements for local partners in some countries. 50:50 JVs are often a default, practical solution when contributions are equal and neither party is willing to give up control. For the past three decades, 50:50 JVs have been the most prevalent ownership structure across industries. Examples include Bosch-Siemens, GE-Mubadala, Royal- Dutch Shell-Cosan, Samsung-Corning, SANAD (Saudi Aramco Nabors Drilling) and Sanofi-Merck.

Particular governance challenges are associated with the this structure: decision gridlock (partners are unable to reconcile strategies and investment interests, and remain trapped in a JV with no clear path forward); lack of partner accountability for JV success, lack of adequate risk management and controls; JV management by a third party (often playing the two partners against each other while pursuing its own agenda).[4]

3.3 JV Purpose & Design

JVs are usually set up with a primary focus on the partners, as opposed to the JV purpose and strategy, with limited to no agreement on several key interlocking elements: why a JV, how will shareholders relate to the venture, what are their expectations in regards to strategy and growth, what will the operating structure be, how engaged should the Board be relative to JV management, and the overall approach to governance. Only 45% of JVs have a Board-approved governance framework or equivalent, outlining how shareholders intend to govern the venture. Before a JV deal is closed it would seem logical for investors to agree on its purpose (the why) and operating/economic model. In reality, investors often have very different views, which are difficult to reconcile. Research indicates that often this is the number one governance challenge, which includes questions of JV degree of independence and its economic model (P&L entity? Cost center?). No JV can remain static, and must be able to respond to evolving market conditions, changing ownership structure or financial positions. There is a tendency for JVs to remain static, possibly because restructuring is viewed as a sign of weakness, despite a strong correlation between JV activity (managing and restricting the core partners of a JV) and return on capital. Materiality of Business Relationships. In the world of public company governance, investors seldom have business relationships with the company (and if they do, these need to be disclosed), while in JVs it is common practice for shareholders to also be major (material) suppliers, service providers or even clients of the JV. Such intricate relationships and commercial

[4] Zanfagna et al. (2020). Decision Making in 50:50 Joint Ventures. Harvard Law School Forum on Corporate Governance. Available at: www.corpgov.law.harvard.edu.
Olie et al. (2024). Antecedents of Independent Directors on Joint venture Boards. Organization Science. University of Warwick. Available at: www.warwick.ac.uk; Bamford (2017). Operationalizing Joint Venture Governance,The Joint Venture Exchange, August; and Bamford et al. (2012).
The Right Stuff: Building a Better Board,The Joint Venture Exchange, August.

interfaces often lack transparency, thus creating governance challenges.

Board Composition Directors are usually representatives and executives of a specific shareholder who elects them, therefore their fiduciary duty is first and foremost to that investor/employer, creating issues of lack of independence. In JVs, investor-management frictions can be minimized by appointing insiders to management and board positions, while the service role of directors (offering valuable expertise, resources and networks) is carried out by the JV partners themselves.

Directors' lack of independence translates into fewer incentives to speak up when things aren't working well. An intervention to improve governance can be interpreted with suspicion or as self-interested by the director(s) representing other shareholders. In addition, if a director speaks up, they risk going against a more senior member of their own company or presenting a non-united front to their partners and the JV management. Few JV directors have annual objectives directly linked to their role on the JV Board, making evaluations and performance tracking convoluted and difficult.

Board Resources Director time and attention to JV governance remains below that of public companies. On average, JV directors spend between 8-15 days per year on their role, compared to 30-35 days per year for directors of public companies. In addition, while public Boards can count on the support of professional and well-resourced corporate secretaries, legal teams and investor relations, JV Boards typically lack these resources to support engagement with or sustained focus on governance.

Board Work Research indicates that JV Boards tend to be inefficient on time allocation: too much focus on operational or financial matters and not enough on strategy, culture and talent management, even less on Board succession planning or JV talent engagement.

Given these challenges, and the fact that JV governance is fundamentally different from that of public companies, what are the foundations of good JV governance?[5]

CHALLENGES OF JV GOVERNANCE

Good governance cannot flourish without clarity of business rationale and modus operandi. This is particularly true in the case of JVs. The foundations of good governance feature JV Purpose and Operating Model, Governance Model, Board Posture or Position, Independent Directors, Board Composition, Partner Governance, Deadlock Governance.

4.1 JV Purpose and Operating Model

Entities entering into a JV must share a common under- standing and agreement of its purpose (the "why" question) and the way the venture will operate. Two important questions require agreement. The first concerns the degree of independence the JV should have and how this could change over time. At the outset, most JVs are extremely dependent on their owners and remain dependent lifelong. Only a few evolve into fully independent businesses. Chevron Phillips Chemical and Dow Corning evolved with a high degree of independence, while Mastercard and Orbitz eventually became listed companies. Having such clarity from the outset allows partners to build a winning formula and a JV governance framework that serves the venture well. The second critical question concerns the JV operating model. Full P&L responsibility might not be the right formula in all cases. Other interesting options include running it as a cost center or as a margin business giving partners access to privileged pricing and deciding whether the JV will live a life of its own (own growth and strategy), as opposed to operating with a limited scope (for instance a manufacturing facility or a local operation). Agreement on these important principles sets the foundations of good governance and avoids ineffective discussions in

[5] Bhargava & Bamford (2021). Research: Joint Ventures that keep evolving perform better. Harvard Business Review, April 12th. Available at: www.hbr.org. Bamford & Bhargava (2020). Independent Directors for Joint Venture Boards,The Corporate Board, January-February.
Bamford et al.(2022). Misalignment Management in Joint Ventures: Drafting JV Agreements to Prevent, De-escalate, and Resolve Disputes. Negotiation Journal, Fall. Available at: www.direct.MIT.edu; Bamford et al. (2020). Joint venture Governance Index: Calibrating the Strength of Governance in Joint Ventures. Harvard Law School Forum on Corporate Governance. March 13th. Available at: www.corpgov.law.harvard.edu.

later stages of the JV life, while recognizing that JVs will evolve and these principles should be subject to revision. Equipped with the partner's agreement on the above, we can lay additional foundations of good governance.

4.2 Governance Model

Defining the JV governance model is a partner duty and (once appointed) a Board duty. The model should clarify how the partners intend to relate to the venture, common expectations towards growth, strategy and evolution, Board engagement relative to management, and how the different pieces of the governance puzzle work together. Studies indicate that defining these elements in corporate bylaws and partner agreements is often insufficient to show how the governance model should work in practice and only 45% of JVs disclose a document or a governance framework that clearly outlines how shareholders want to govern. Those who do, have a solid governance foundation to build Board posture.

4.3 Board Posture or Position

Commonly accepted and/or mandated norms in relation to Board fiduciary duties (for instance oversight on performance and risk) or Board responsibilities (to provide input into and approve corporate strategy or oversight of culture) do not exist in JV governance. Therefore, there isn't clarity as to Board posture or position vis-à-vis governance norms or how involved the Board should be. Very few JVs (less than 10%) have a Board that acts like a corporate Board. To clarify the question of Board posture partners should discuss what type of Board the JV should have, Options range from a least engaged Board ("hands off style") to a highly engaged "Board of Managers" and any variation in between. The latter is a governance structure that manages the JV and can delegate operational management to one or more officers. JV parties usually have the right to appoint and remove directors, including independent directors.[6]

4.4 Independent Directors

It can be very valuable in large JVs, in JVs that intend to go public or in the case of more than two partners. They can bring expertise that partners might not have and the JV needs; they can add gravitas to the JV, enhancing its stature through prominent industry experts; they can also act as conflict solvers and representatives of smaller partners whose individual stakes do not allow them to appoint their own directors on the Board. Independent directors can also successfully enable the pre-IPO to post-IPO phase of a JV life.

4.5 Board Effectiveness

The lion share of JV Board time goes towards managing financial and operational performance, possibly because most directors are executives of one of the parent companies. It is best practice to invest time in areas such as strategy, culture or JV talent management, often neglected in busy Board agendas. To increase Board effectiveness, better to avoid using Board meetings for directors to get educated on JV issues. For nimble JV governance (reminder: most JVs are intended to be nimble vehicles for value creation), directors must be required to come prepared to Board meetings so that time can be spent on discussions (as opposed to lengthy presentations).A good idea is to tag each agenda item based on its why (purpose): Board education, discussion, decision, advice and reflect post Board meeting on whether the intended goal was achieved. Elevating Board effectiveness also requires Director Onboarding and training to address the unique challenges, requirements and risks facing JV directors.

[6] Holland (2020). Structuring Joint Ventures: Building a solid Governance Foundations for Strategic Alliances. Greenberg Traurig, July. Available at: www.ACC.com.
Bamford & Walker (2022). Closing the Governance Gap in Joint Ventures. Fall Issue. MITSloan Management Review. Available at: www.sloanreview.mit.edu.

4.6 Board Committees

Committees can be very useful in JV governance, helping the Board to get things done. They can however also create issues. JV committees tend to be staffed with functional experts who do not serve on the Board and work on many areas (procurement, finance, regulation etc.), potentially undermining JV management responsibility. Practical steps to avoid such emphases include limiting the number of committees and requiring each committee to have at least one director.

4.7 Partner Governance

Partner governance is about JV partners intentionally thinking about how they want to organize themselves internally in the service of good governance. In essence, beyond approvals and audits, this is about partners ensuring that the JV receives the expertise and time investment it needs beyond funding. Partner governance can be enabled by an internal "governance team" in large JVs by a JV Governance Manager typically reporting to the managing director/board and managing relation- ships (JVs in certain industries, such as aerospace, defense, power, automotive, industrial often have small partner governance teams); in smaller JVs this function can be assigned to a "functional expert" (strategy, legal, compliance) or a full time, senior corporate secretary.

4.8 Deadlock Governance

A deadlock is typically JV partners' inability to reach a majority or unanimous approvals required to authorize an action or transaction. They are common in JVs. Governing deadlocks means finding methods to solve them. These include asking partners to agree on a set period of negotiation (beyond which agreement must be reached); enabling an independent member of the JV Board to unlock the deadlock; effective and clear escalation paths into the partners' C-suite (on average the threat of such escalation path acts as deterrent to deadlocks). It is critical to document the typology of disputes that can be escalated, the named individuals to whom issues are escalated and a clear resolution timeline. Partners can also plan for and make use of arbitration or mediation, in which case the JV Board should document provisions for arbitration or mediation, including which types of disputes are in scope and the use of individual mediators or arbitrators versus a panel. Eventually, the consequence of a deadlock that cannot be solved is usually the dissolution of the JV.[7]

[7] Gulati et al .(2022). Modernizing The Board's Oversight of Joint Ventures .The Conference Boards, September/October. Available at: GulatiBamfordWalker 2022

LOOKING AHEAD

Good governance matters to JV performance and JV performance matters to their partners and their investors. It is time for greater rigor, independence, and research focus to help develop good governance practices that can help JVs to be successful. JV governance has so far escaped the scrutiny of public companies' governance and has received far less attention from regulators, the media and the public.

Good JV governance boils down to clarity of purpose and operating model, goal alignment and a shared expectation for the JV to evolve over time and therefore its governance to evolve with it. At the heart of JV difficulties are often poor partner relations. Having clear partner roles, equal shares of risks and benefits, trust in the JV CEO, being ready for things out of the ordinary to happen (particularly those that will pit partners against one another and the need for mediation or compromise) and having well defined exit mechanisms when deadlock happens or conflicts terribly escalate are key remedies to common JV troubles. Companies should pay attention.

ABOUT US

The Centre for Governance CFG was established by the Public Investment Fund in 2020. We aim to drive sustainable value creation for Saudi Arabia by enhancing the corporate governance practices. CFG is designed to provide unique solutions to its corporate clients as well as the individuals looking for upskilling programs in the governance domain. Beside the capabilities we have internally, CFG leverages the excellent relationships it has with the world's best institutes and leading global consulting firms. If you would like to learn about our Board Programs and Governance Advisory Service, contact us at info@cfg.sa.

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