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A Cautionary Note**
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**Joint Ventures And The Entrepreneurial Small Firm:
A Cautionary Note**
CHARLES A. SCHAFFER*

In joint ventures, definitions are important, since the term "joint venture" usually applies to a very large range of agreements through which firms work collaboratively. As used here the term means an agreement involving two or more firms to use some of the assets or resources of each, by way of contracts or transactions, to perform some action providing a payoff to each firm. This definition includes traditional joint ventures where the participating parties create a new entity, jointly owned by the parties, and the now more frequent "corporate partnering" or "strategic alliance," where the parties collaborate without changing the boundaries of the participating firms or changing the ownership of assets. It does not include mergers where all the assets of the participating parties become part of a single firm, nor does it include acquisitions where one of the participating parties controls the collaborative activity.

Over the past twenty years a substantial body of management literature has emerged, both academic and practical, that stresses the value of joint ventures to a firm's competitiveness. In that literature, small entrepreneurial firms are good candidates for joint venture activity when they are innovative and risk-taking, but resource or asset-constrained. These firms can leverage up their capabilities in cash, equipment, personnel, patents, and processes, through collaboration with one or more firms of the same or different size. Joint ventures allow firms to:

- Work at the point of convergence of disciplines (e.g., "bioinformatics") to develop new products and obtain first mover advantages
- Secure scope economies and cost reduction in industries or product lines where the same or very similar production processes can be used for multiple manufactured products (e.g., chemicals, pharmaceuticals)
- Share the costs of research and development
- Overcome costly barriers to market entry or line up customers, suppliers or distributors in advance of new product development or introduction

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- Secure new financing directly or improve the attractiveness of the participating parties or their joint venture to traditional sources of debt or equity

A joint venture can be of long or short duration, can be structured through formal contracts or more informal relational agreements, and can provide for changes in the use of the participating parties' assets. When added to this very large range of purposes, it is a complicated choice whether to enter a joint venture and limit the application of traditional industrial organization and industrial economics principles. The legal literature, at least as large as the management literature, offers little help, confining itself to post-choice issues of structure (e.g., avoiding unintended partnerships and antitrust liability), capitalization (e.g., investor's rights, recovery of investment or loans), and taxation (e.g., entity choice, taxation of non-liquidating distributions).

Making the Choice to Enter a Joint Venture

As in all costly business efforts, it pays to "look before you leap" into the commitment of resources. Here are some real-life suggestions to guide the decision whether, and with whom, to engage in a joint venture.

A Caveat on "Relational Contracts"

There is no substitute for a formal agreement setting out in detail the parties rights and obligations in the formation and conduct of the joint venture and their intention to have the agreement enforceable in court. In recent years there has been a fair amount of interest in the possibility of joint ventures using less formal "relational contracts," relying less on third party enforcement and more on enforcement through reputation, shared interests in outcomes, the promise of future opportunities.

No one can write a contract complete enough to address every possible contingency. To their proponents, relational contracts are better than formal contracts that will require renegotiation with attendant transaction costs and costs of delay and lost opportunity. Many examples of such relational contracts are drawn from the actions of firms in Silicon Valley engaged in relational activities related to market or industry structure (e.g., standard setting for software or hardware compatibility). Unfortunately, the use of such examples is disingenuous since one cannot in real practice extrapolate from a firm's willingness to use relational mechanisms in market or industry related

actions to a willingness to use such relational mechanisms in conduct-of-business or business competitive actions.

Even in Silicon Valley, individual firms use formal, complete contracts for matters of technology licensing, intellectual property and product development. While renegotiation or amendment of such agreements is costly, those costs are usually less than the costs associated with project “hold up” sustained by the actions of one party to a relational contract who, for example, balks mid-project on the continued use of one of its assets.

Even if parties believe that their goals can be achieved using relational contracts, it is very doubtful that bankers or investors in the joint venture (or in the parties individually) would permit such action that puts at risk their loans or equity in an agreement not enforceable in court.

Clarification of Purpose and Scope

Joint venture parties should articulate early, clearly, and consistently the desired outcome of each party and the relationship of that outcome to the joint scope of work and contribution of assets. Joint ventures offer considerable opportunity for the problem of adverse selection where one party has information not available to the other party in the form of a hidden agenda at odds with the purposes of the venture understood by the other parties.

Consider, for example, a small manufacturer of chemical glues and resins that entered into a joint research and development effort with a paint manufacturer. To the chemical firm the clear purpose of the work was the joint development of a new, long wearing paint for special applications where ordinary paint would not bond well to the surfaces to be painted. As work progressed the chemical firm’s technicians noted reluctance on the part of the paint firm’s technicians to carry the work to conclusion. Their withdrawal of effort and resources held up the project. When confronted, the paint firm admitted that its real reason for entering the joint venture was to develop glue for manufacture in the firm’s current physical plant without adding new technology or equipment. The development of paint was, the firm admitted, a secondary goal to acquisition of the chemical firm’s knowledge of glues and resins.

The articulation of the relationship between desired outcomes and performance of the scope of work is important to prevent a problem of moral hazard. Traditional moral hazard is a hidden action problem —

one of the parties to an agreement shirks its duties because its actions are not immediately observable or verifiable by the other party. In joint ventures a significant variant of this can occur when outcomes and conduct of work are less than clearly articulated and a less than optimal level of effort is sustained, because the wrong people are involved in the effort.

For example, a high level of misdirected and wasteful effort frequently occurs in organizations that seek to implement new computer applications technology into their operations. Although the major issues associated with adoption and successful use of such technology are policy or line operational issues, it is frequently technical staff who control the technology adoption planning. The result is long discussion of "plug A vs. plug B," with little attention to the issues associated with the practical use of the technology in achieving desired outcomes by end users. In addition, when joint venture outcomes are not tied to the actions of the parties in some scope of work, there is an incentive for one party to free ride on the actions of another by contributing the minimum effort.

Considerations of Risk

Before deciding on a joint venture, the parties need to remember that in every joint venture there is a participation constraint. No matter how complimentary the parties' goals or how well directed joint efforts are toward those goals, no party is guaranteed to leave the venture better off, or even as well off, as it entered. Each party has to look at its own and others' degree of risk aversion and risk tolerance and determine if they are immediately congruent or can be made so through structure (limited liability) or conduct (indemnification) of the joint venture.

Risk aversion and risk tolerance are not the same thing. Risk aversion is the degree to which a party demands some premium over a risk-free level of return for taking a given level of risk. Firms demanding such a premium are said to be risk averse; firms not demanding such a premium are said to be risk neutral. Risk tolerance is a measure of a party's willingness to sustain some determined level of risk over time for a given level of return. It is possible, then, to be at the same time very risk averse (by demanding a high premium over risk free return) and very risk tolerant (in the presence of that high return the risk can be sustained at a high level for a long time).

Depending on the decision making structure of the joint venture, it is possible for a party to find itself sustaining uncomfortable levels of risk. For example in cases where there are more than two parties to a joint venture, and where unanimity of the parties is not required for

venture decisions the risk aversion and risk tolerance preferences of a party with regard to three possible courses of action a, b, c, do not necessarily carry over into the preferences of the group. Known as Condorcet's Paradox the problem works like this. Three individuals – I, II, III – are joint venturers rank ordering as 1, 2, 3 their individual preferences for three possible outcomes – a, b, and c – which represent differing degrees of risky action. 1 indicates first preference; 2 indicates second preference; 3 indicates third preference.

	a	b	c
I	1	2	3
II	3	1	2
III	2	3	1

Condorcet's Paradox

In the table, two members prefer a to b. Two members prefer b to c. But two members, a majority, still prefer c to a. If the parties were voting, the group's choice would be inconsistent with the choices expressed as individuals. Absent agreement on the conduct of the joint venture, the parties' actions in the joint venture may not maximize the outcome for every party.

Unanticipated Effects

A careful pre-agreement review can avoid unanticipated costs and unintended consequences of the joint venture. In the matter of costs, for example, two surgical equipment manufacturers engaged in a joint venture that involved in its conduct the loan of an ethylene oxide gas sterilizer by Manufacturer X to Manufacturer Y. New to the technology, Manufacturer Y found itself with substantial additional insurance premiums due to the hazardous nature of the gas used in the sterilization. It also sustained both new and incremental regulatory costs associated with occupational safety and pollution control compliance. An often overlooked and unintended consequence relates to the creation of joint employment situations by joint venture agreements.

Minnesota, for example, has adopted the "loaned servant" doctrine for workers compensation purposes. If certain conditions are satisfied, an employee can be simultaneously in the general employment

of one employer and the special employment of another. The employee may look to either or both employers for compensation under the state workers' compensation law.

For some purposes, in some industries, joint ventures may not yield persistent, sustainable results. Costly research and development joint ventures may not be the most effective or efficient choice in industries where there is very rapid dissemination of new technological innovations, where the speed of product improvement and new product introduction precludes a "winner take all" long term market share for any one firm. There may be benefits, such as the avoidance of sunk development and testing costs, of being a second mover not a first mover in a market. Similarly, using a joint venture to overcome barriers to entry into a given industry or market may not have sustainable effect when new entrants must compete long term with incumbents possessed of substantial market power or economic rents. Entering a market does not make a firm a competitor in that market.

All parties to a joint venture will sustain some transaction and opportunity costs associated with the use and control of their assets and resources in the joint venture. A pre-agreement review of the kinds of issues noted above will help the parties ensure complementarity of purpose and conduct and prevent expense, frustration and disappointment.