Patterns of Internationalization for Developing Country Enterprises

(Alliances and Joint Ventures)

UNITED NATIONS
INDUSTRIAL DEVELOPMENT ORGANIZATION

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Prepared for UNIDO by
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Acknowledgements

This publication is based on more than 20 years of the United Nations Industrial Development Organisation (UNIDO) experience in assisting developing countries to formulate appropriate policies and tools at the country level and in assisting individual enterprises to assess and formulate joint venture agreements.

It was prepared by José de Caldas Lima,[1] in cooperation with F. Mithat Kulur, Chief, UNIDO Investment Promotion Unit, Investment and Technology Promotion Branch.

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introduction

This training package is addressed to entrepreneurs and policy makers in developing countries. It deals with issues of internationalization at the enterprise level and their impact on economic growth and social development at the national level. Globalization brings with it an aggressive competitive environment and a scenario of continuing and accelerated change requiring timely and effective responses; it also brings opportunities which are opened by the liberalization of markets and the evolving strategies of multinational enterprises (MNEs). In particular, it is important to understand and, when possible, to exploit the MNEs' market entry strategies and the way they organize and manage their manufacturing activities at the global level in order to minimize risks and take advantage of cost savings and efficiency gains associated to different locations.

Foreign direct investment (FDI) and other forms of association to MNEs operations, such as subcontracting, original equipment manufacturing (OEM), participation in global value chains (GVCs), global manufacturing networks (GMNs), joint ventures (JVs) and various kinds of alliances have been the movers of technological progress, economic growth and success in international markets for many developing countries. Success stories are widely known and will be highlighted in this work. But it has to be emphasized that success is not an accident, and successful experiences cannot be simply transplanted. MNEs take their strategic and locational decisions on the basis of their stakeholders' interests, and this includes perception of risks, profit expectations and pursuit of increased market share; host countries, on the other hand, have their own set of values and endowments, cultural and social patterns, and development policy options. Furthermore, the characteristics of industry competition and factor markets are constantly changing, which adds to the complexity of the situation confronting developing countries and their enterprises, in particular those with inadequate levels of technological capacity and insufficient access to information on opportunities for internationalization.

This training package is intended to be an instrument to help firms of developing countries improve their competitive position and grow domestically and internationally by linking with foreign partners, leveraging the relationships with them, and learning further in order to achieve technological self-sufficiency and innovative capabilities of their own. In this connection, particular attention will be given to joint ventures and alliances, including the motivations of the participating enterprises, the opportunities for partnerships, and their negotiation, implementation and management. While the main expected users of this package are developing country entrepreneurs, and special focus is given to the subject of alliances and joint ventures, it was found convenient to frame the package with a supplementary body of knowledge based on two kinds of considerations:

First, the development of entrepreneurial activities involves issues that are of interest to policy makers. When thinking of technological progress at the enterprise level in developing countries, and the contribution of joint ventures and alliances to achieving this aim, one has also to consider the role and interplay of many enabling factors, such as:

- international political and development agenda, related rules and conventions, and multilateral and bilateral agreements and what they mean for a country in terms of constraints and opportunities;
- the country's macro-economic and policy environment with its institutions and regulatory framework and how they influence entrepreneurial activities and induce the activities of foreign enterprises;
- the physical and technological infrastructure available in the country, the national innovation system, and the mechanisms in place to support technological development and innovation at enterprise level.

Second, the opportunities for internationalization available to firms of developing countries are dependent upon the business strategies of multinational companies and the way they manage their global operations.

This training package will therefore bring to both policymakers and managers of enterprises of developing countries not only an awareness of the international development scenario and the competitive forces they have to cope with, but also an understanding of the strategies and behaviour of multinational companies, of the opportunities available for growth and internationalization in that context, and of how to seize and take advantage of such opportunities. Related to this, the package will enable the users to handle the practical issues associated to the preparation, formation, negotiation and management of the various types of alliances and joint ventures that firms of developing countries may wish to enter into with foreign partners.

The envisaged purpose is to focus on joint ventures and alliances as a path for growth and internationalization for developing countries' firms and at the same time shed light on the conditions under which they have to operate, find their opportunities and make their choices. To achieve its objectives the package will be developed in four main parts as follows:

Part 1 presents the international development scenario, the competitive environment and the drivers for the global expansion of enterprises. It highlights the patterns of multinational expansion, the various types of inter-enterprise collaboration agreements, the global manufacturing strategies of multinational enterprises (MNEs) and the related challenges and opportunities for developing countries.

In this context, part 1 elaborates on the role of global value chains (GVCs) and global production networks (GPNs) as elements of MNEs' global operations management and as vehicles for the technological development of developing countries' firms. Attention is also given to the role of developing countries' governments in creating suitable locational conditions for MNEs and in providing critical support to domestic enterprises in their path for technological capability building and internationalization.

Part 2 deals with the subject of business alliances in its broad scope, first, by attempting to clarify the currently used and sometimes blurred terminology; then, by reviewing the main forms of business alliances together with their specific and distinctive features; and, subsequently, by moving into the more specific areas of strategic alliances and joint ventures. It analyses the concept of strategic alliances and highlights their main characteristics and the relevant issues associated to them, and introduces the various types of joint ventures found in international business operations, focusing on the notion of equity joint venture as a form of cooperation between international companies or multinational enterprises (MNEs), on the one hand, and domestic enterprises of less-developed or less-industrialized countries, on the other.

Part 3 is at the heart of the package. It covers the whole process of implementing joint ventures, both as a form of foreign direct investment and as a framework for cooperation and development where foreign investors, their partners in developing countries and the host governments, all have specific interests and expectations that have to be accommodated.

With this reality in the background, part 3 elaborates on the partners' motives and possible ways of obtaining their engagement, the various steps and phases in the development of a joint venture relationship, and the joint venture agreement as the instrument that, together with the applicable laws of the host country, sets out the rules that govern the

relationship between the partners and the formation, incorporation and management of the joint venture company as a separate legal entity.

Part 4 deals with the subject of negotiations and contracting, having in mind that the success of a joint venture as a long-term business relationship depends to a great extent on the ability of the parties to negotiate and bridge their specific and individual interests to achieve mutually acceptable deals.

Part 4 is developed around two main components. One of them covers the aspects of international business negotiations, including the basic principles of negotiation, negotiation strategies, tactics and techniques, and the cross-cultural aspects involved. The other component highlights, on the one hand, the importance of a contract as a legal instrument that sets out the agreement arrived at by the parties and governs their business relationship and, on the other, provides guiding principles for proper contract formulation and drafting.

In terms of structure, the package comprises the following basic elements:

- A textbook component, intended to cover the overall body of knowledge and presented in a way that is both comprehensive and easy to read;
- A glossary of terms and definitions aimed at supplementing the textbook with further explanations and clarifications on selected terms and concepts;
- A set of annexes containing samples of different types of contracts and other legal instruments, such as letters of intent and memoranda of understanding, to illustrate how the issues of negotiation are reflected in the drafting practice;
- A set of visuals directly related to the overall content of the package, in particular to the textbook part, and intended to support the implementation of training programmes addressed to managers and government officials of developing countries concerned with the development and internationalization of their enterprises.

1 The international scenario for business and development

1.1 Overview of international business

1.1.1 The evolution of multinational strategies

The strategies and forms of international business have continuously evolved in the last few decades as a result of continuing progress in technology, liberalization of investment flows, and increased competition among enterprises.

The early decades of the twentieth century witnessed the multinational expansion of European companies, such as Unilever, Royal Dutch Shell, ICI and Philips. That was a time when the conditions for internationalization were characterized by:

- slow and costly transportation and communication;
- highly differentiated national markets.

In this context, national subsidiaries of multinational enterprises were given operational autonomy to undertake their own product development, manufacturing and marketing. The role of the parent company would not go much beyond the appointment of senior managers, the authorization of major expenditures, and the collection of dividends from subsidiaries. Some authors describe these companies as multinational federations.[2]

Phases and models of multinational expansion

- Early 20th century: expansion of European companies (decentralized federations)
- 1950s and 1960s: prominence of U.S. multinationals (coordinated federations)
- 1970s and 1980s: emergence of Japanese firms (centralized hubs)
- Present situation: complex global networks; virtual corporations; metanational firms

In the 1950s and 1960s, following the emergence of the United States as the world's dominant industrial power at the end of World War II, US multinationals like GM, Ford, IBM, Coca-Cola and Procter and Gamble, took a prominent role in international business expansion through their foreign subsidiaries. Although such foreign subsidiaries were operated with a substantial degree of autonomy and aimed at supplying local or regional markets, the parent companies retained a dominant position in the strategies and operations of the whole group.

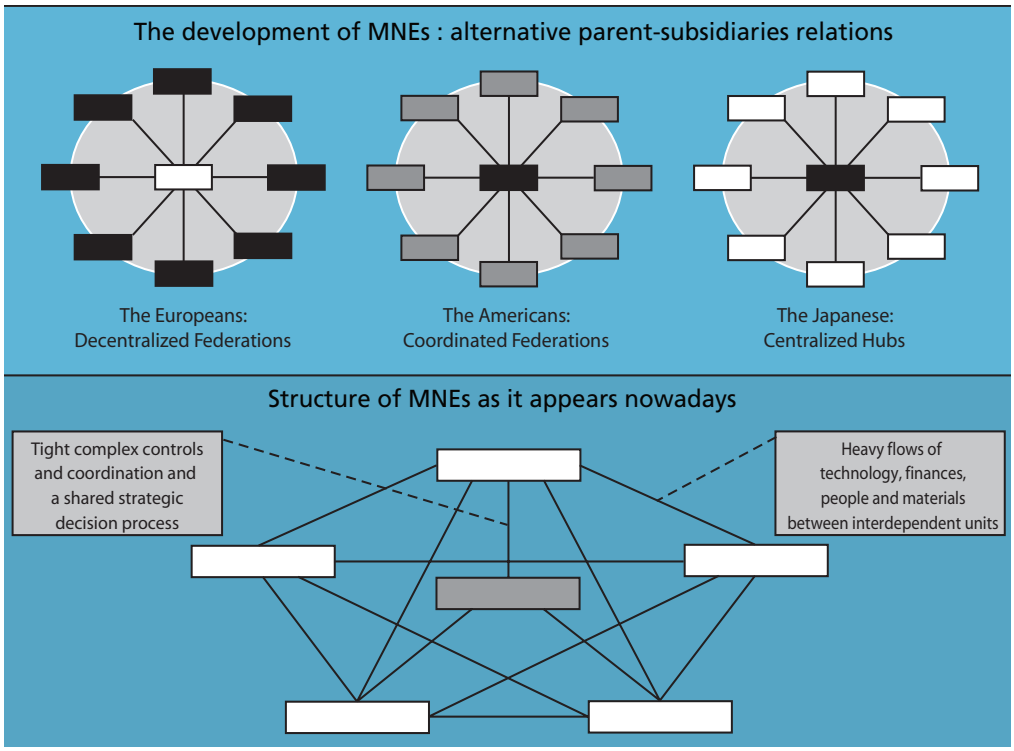
Typically, the parent companies would act as the source of capital, technology, innovation, decisions on the introduction of new products, and management capabilities. It was their continuing access to the capabilities of the parent company that gave the overseas subsidiaries their competitive advantage in the national markets.

[2]Grant, Robert M., 2005.

During the 1970s and through the 1980s, Japanese companies appeared as leading global players at a time when Western multinationals were in a trend of divestments, rationalizations and host country plant closures.[3] A characteristic of the Japanese international expansion, which became more conspicuous in a number of manufacturing industries, from shipbuilding to automobiles and consumer electronics, was the pursuit of global strategies commanded from centralized home-based headquarters.

According to those strategies, R&D and manufacturing activities were concentrated in Japan, in large-scale operations producing globally standardized products. Overseas subsidiaries would handle sales, distribution and customer support. Thus, while Japanese firms have followed the trend of setting up manufacturing operations overseas, they still keep a strong global integration in their operations.

Figure 1.1 Structures of multinational enterprises



Source: Robert M. Grant, 2005.

Through the 1980s and 1990s, and as a way to respond to increased international competition, multinational companies had to exploit multiple sources of competitive advantage. For that purpose, they evolved into complex structures that:

- reconciled the advantages of global integration with those of national differentiation;
- benefited from forms of decentralization conducive to generating innovation and from the global centralization needed to more efficiently exploit these innovations.

[3]Stonehouse, George, 2004.

From the early forms of decentralized federations, multinational companies became complex structures of globally coordinated and integrated operations, which evolved dynamically not only in the relationships between headquarters and national subsidiaries but also in a shift towards increased outsourcing of non-core activities, and the development of global production networks and strategic alliances.

Furthermore, the twenty-first century is witnessing the emergence of the "virtual corporation"[4] and the "intelligent organization",[5] the first concept meaning a corporation basically acting as a networking centre that outsources practically all of its operations, and the second concept applying to organizations that seek competitive advantages through organizational learning and knowledge management.

1.1.2 Terminology of multinational business

The enterprises involved in international business have been referred to in different ways, for example transnational corporations, global corporations, multinational enterprises, and so on. Sometimes the terms are intended to designate a specific type of operation, or strategic approach, or spatial location, but often such terms are used interchangeably in the current literature. Their meanings can also vary from author to author and even change over time.

In order to avoid much confusion to the users and give some clarification of the current terminology, we provide below an overview of the most currently used terms and the notions commonly associated to them. Nevertheless, throughout this package, we will use multinational enterprise (MNE) as an embracing term, encompassing the features that characterize today's international, multinational and global manufacturing and business operations.

Overview of current terms:

International business and international company. These terms imply business across national boundaries and operations in more than one country. They are generic terms, and the different types of international operations that bring international companies together can be better characterized by specific terms such as "sourcing of raw materials", "exporting of products into foreign markets", "joint ventures", "licensing agreements", "outsourcing of products and services", "strategic alliances", or even "taking equity positions in overseas ventures without significant management involvement".

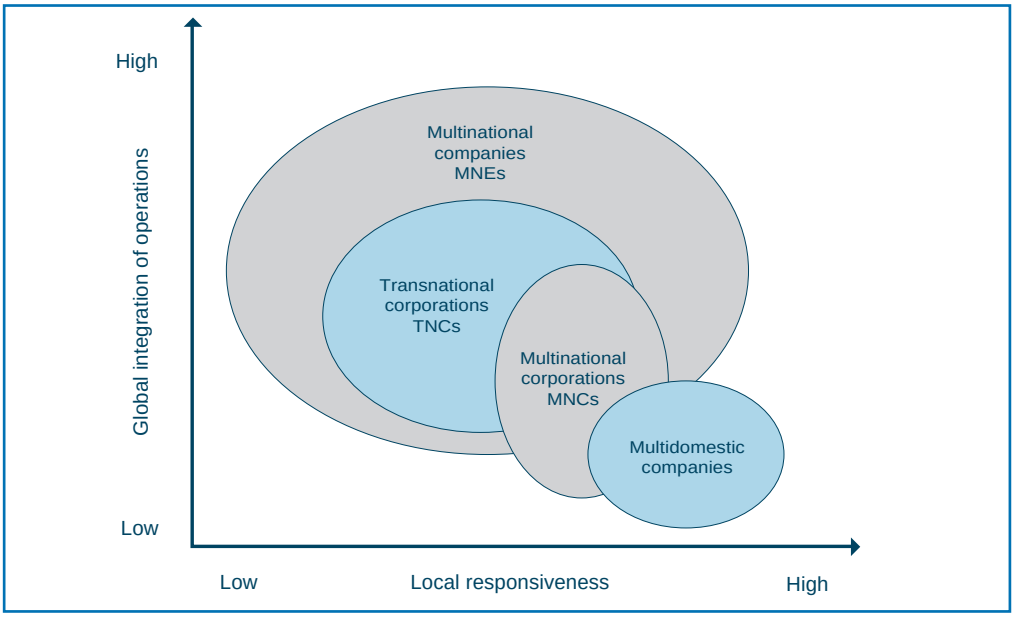
Multinational company and multinational corporation (MNC). In the earlier days of the 1950s through the 1970s, multinational companies or multinational corporations were regarded as enterprises with operations and control of assets, such as factories, mines, sales offices and the like, in several different countries. It was the practice at that time for the multinational companies to operate through overseas subsidiaries, which were allowed substantial autonomy in their strategies, aimed at addressing the local conditions and had little coordination across national boundaries.

Transnational company and transnational corporation (TNC). These terms have been applied to business and companies with activities across national boundaries, which are

[4] *See* Glossary.
[5] *See* Glossary.

coordinated, integrated and differentiated in terms of strategies and operations in order to take advantage of, or suit market and business conditions and opportunities. The term transnational is used in connection with the pursuit of global competitiveness[6] through the configuration, coordination and control of business activities in a way that takes into account both global and local advantages and opportunities.

Figure 1.2 Terminology of multinational business



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Multinational enterprise (MNE). This term is gaining wide acceptance in the United Nations system, and in particular in UNIDO literature, to designate companies that use the various modes of operations presented so far. In general terms, this means that a multinational enterprise takes a global approach to foreign markets and production locations, whether through subsidiaries, through out-sourcing or through the integration of global value chains or global production networks. Although the usual notion of multinational enterprise brings to mind the idea of giant companies from industrialized countries, nowadays there are relatively small companies, owned by nationals of developing countries, that also take global approaches to their operations and use most of the business forms presented above.

Global company and multidomestic company. These are terms sometimes used to highlight and differentiate the geographic focus and the management strategies of companies with international operations. A global company, also called a globally integrated company by some authors, on the one hand designs products and services intended to be branded and sold on a global scale; and, on the other hand, integrates operations in different countries to source materials and produce or acquire components which integrate its products and services. A multidomestic company, also called a locally responsive company, is one that designs products or services for specific domestic markets and allows substantial independence to its foreign country operations.

[6] *See* Glossary.

Metanational company. This is a term applied to a newly proposed model of international business intended to go beyond the current transnational or multinational or global forms. According to this concept, an indispensable source of competitive advantage for enterprises in the future should consist in creating three areas of activity:

(a) prospecting and identifying new sources of knowledge, competencies and innovative technologies around the world;
(b) integrating those scattered capabilities to disseminate knowledge inside the company to pioneer new products and services; and
(c) imparting the innovations into the operations network and using the global operations to leverage metanational innovations rather than just relying on and propagating home-based concepts and developments. In a metanational company, the headquarters should be regarded as a node in a network and no longer a centre radiating knowledge and technology to the world.

To sum up: there are different forms of international business operations and different terms to designate them. Sometimes the terms are intended to convey a specific characterization of companies' strategies and spatial distribution of their operations; but, in general, the meanings of the terms currently found in the literature are blurred and vary according to the sources. In this package, we will adopt the terms multinational enterprise (MNE) and multinational business in a generic and embracing way. We will also use the terms global business and global enterprises interchangeably. In the following sections, we will dissect and analyze the drivers of multinational business and the operations of multinational enterprises in detail, thus providing the reader with the full picture to which all the above terms and concepts refer.

1.1.3 Global expansion and market entry strategies

Globalization drivers[7]

Growth is an inherent vocation of business enterprises and also represents a survival imperative. The competitive pressures and the need to keep and strengthen their position in the market, force enterprises to stay on permanent alert and explore opportunities to achieve advantage over competitors and expand beyond the limits of their domestic markets.

The expansion of enterprises into the global market place becomes a necessity not only because of the confines and limitations of their domestic markets but also because in a globalized world the market share in the domestic market becomes threatened by foreign competitors. Several specific factors drive enterprises to seek business development and growth through international and global operations, namely market, cost and competitive factors, and the international business environment.

[7] *See* Reading Materials, *Globalization Trends.*

Globalization drivers

- **Market factors:** Improvement of living standards and global consumption patterns
- **Cost factors:** Increased development costs andthe need to achieve economies of scale
- **Competitive factors:** Pressure of competitors in the domestic and foreign

Market factors. The information and communication technologies, the massive development of international tourism, the widespread cultural exchanges and the improvement of living standards in a number of developing countries resulted in the emergence of consumer groups in different countries and regions of the world with comparable educational backgrounds, lifestyles, purchasing power, needs for goods and services, and aspirations to quality standards. This scenario, combined with the liberalization of international trade and the availability of global distribution channels, opens wide opportunities for enterprises to market their products and services on a global scale.

Cost factors. Market leadership compels companies to invest heavily in R&D and innovation to develop new products or to improve and differentiate existing products. In the car industry, for example, the introduction of a new model may represent an investment to the tune of one billion dollars. In the pharmaceutical industry, the cost associated to the successful development of a new drug is of the same order of magnitude. In the consumer goods sector, the cost of promoting a new brand could be as high as $US100 million. A single domestic market would not allow companies to achieve economies of scale and to break even on such costs, hence the need to project operations with the global market in mind.

Competitive factors. One of the reasons for enterprises to pursue global strategies is to keep or gain advantage over competitors in foreign markets and to stave off competition in the home market. Going global would allow for economies of scale and consequent flexibility to win against competitors in the home market through undercutting prices, if necessary; on the other hand, an effective strategy to hold a competitor at bay could consist of bringing the pressure of competition into its own home market.

International business environment. Several factors have contributed to the globalisation of the business environment. The trend towards the liberalization of trade and investment flows, which emerged in the 1980s and took an irreversible course, gave impetus to the globalization of both markets and enterprises' operations. The advances in communications and information technologies also contributed to the globalization process in as much as they provided the instruments that made global operations easier and more manageable. Newly emerging markets have also recognized the economic benefits, technological progress and growth opportunities that globalization can bring to them, which encourages further and friendlier measures to attract international investors and business enterprises.

1.1.4 Globalization of small and medium-sized enterprises[8]

Globalization as a business strategy is not exclusively for enterprises with a traditional international vocation. Many small and medium-sized enterprises also go global nowadays for a variety of reasons, which can be categorized into proactive motivations and reactive motivations.

Proactive motivations. These are the reasons why companies want to and decide to go global. Proactive motivations basically result from the assertion that the company has developed a technology in the form of a process, a product, a service or a business concept that has a competitive advantage and the potential to win a position in the global markets. This could be the case with enterprises with innovative technologies or unique products with a particular advantage not available from competitors and with potential demand not only in the domestic market but also in foreign markets. Enterprises may also decide to go global because they have received special information about promising customers or market opportunities abroad, or are motivated by incentives of some sort, like tax benefits granted by foreign governments. Of course, the major underlying motivation is the quest for increased profit, which means the need for increased output to benefit from economies of scale and the consequent drive to expand business beyond the national boundaries.

SMEs' motivations for international business

PROACTIVE	REACTIVE
• Quest for profit	• Competitive pressure
• Competitive advantage	• Excessive capacity
• Market opportunities	• Overproduction
• Economies of scale	• Saturation or decline of home market
• Tax benefits	

Source: Adapted from Czinkota, M., Ronkainen, I. and Moffett, M., *Fundamentals of International Business*.

Reactive motivations. Enterprises may need to think of entering foreign markets as a reaction to changes in the domestic economy, in the market conditions or in the competitive scenario. For example, if their domestic market share is threatened by the competitive pressure of foreign entrants, they may look for expanding sales abroad. This will result in increased production and cost reduction through economies of scale and will make the enterprise more competitive at home too. Reactive motivations are also typical in such cases as:

(a) excessive capacity, i.e. the available equipment is not fully utilized and part of the economic benefit is lost because of inadequate distribution of fixed costs, in which case expansion abroad will be regarded as a solution;

(b) overproduction, which happens in periods of economic downturn and leads enterprises to seek foreign outlets for their excessive inventories; and

[8] *See also* "The case of born-global enterprises" in section 1.1.6.

(c) saturated or declining domestic markets, for example as a result of changing consumer tastes or the displacement of current products by the latest innovations—the life cycle of the "outdated products" can be extended through selling them in foreign countries where they could be appropriate to local conditions and needs.

1.1.5 Patterns of expansion

Considerations about internationalization

For many companies the internationalization process is undertaken with caution as a stepwise process involving strategic planning and a risk-minimization approach. In principle, companies will choose the markets and the entry modes which appear more familiar and less risky, and will afterwards move into deeper levels of international commitment as they gain experience and feel more confident about foreign business.

When companies become aware of business opportunities abroad or recognise the need to expand into foreign markets, the ensuing internationalization has to be undertaken methodically and competently, otherwise it may end up in failure and the irreparable waste of resources. Fist of all, internationalization requires management commitment because it also requires the sustained allocation of valuable staff resources, market and competition analysis, and financial investment. Furthermore, in business operations in foreign markets, companies are confronted with problems very different from those arising in the domestic market, which are well known and more easily solvable.

Foreign markets vs. domestic markets: distinctive elements

- Political, social and cultural factors
- Local and related international laws
- Geography and natural conditions
- Infrastructure and manpower

Implication: Internationalization is undertaken with caution as a stepwise process involving a strategic planning as well as a risk minimization approach.

Foreign markets, as compared to domestic markets, usually have significant differences in various areas that companies have to consider:

- *Political, social and cultural factors* may have a bearing on the practical ways of conducting business and on the characteristics of company's products that will be acceptable to local consumers, bearing in mind their social and cultural values, beliefs and attitudes.
- *Local and related international laws* determine what managers can and cannot do: the relations with the labour force, the level of taxation in the foreign country and the taxation of foreign earnings in the home country, and the possibility or the security of operations in certain countries.

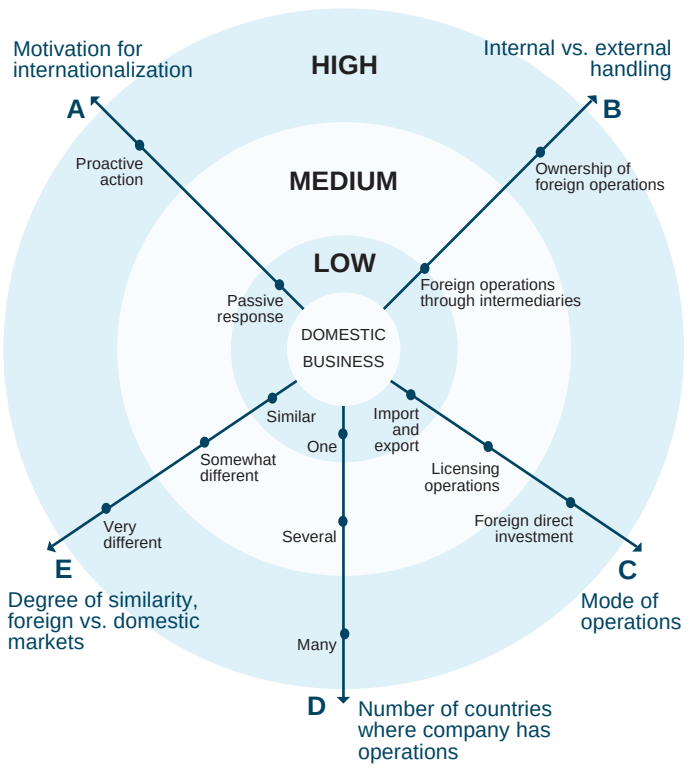
- *Geography and natural conditions* and their impact on business should be assessed; the difficulty of access to landlocked countries or geographical obstacles like mountains or deserts may represent burdensome additional costs and risks.
- *Infrastructure and manpower;* for example, the availability of roads, ports, telecommunications and skilled labour are also important elements that influence the distribution and manufacturing costs and the ability to manage operations.

The evolutionary process of expansion

As highlighted above, companies will move with caution from the domestic market into international markets according to prudential patterns of expansion. These are illustrated in figure 1.3. The expanding circles depict the various levels of internationalization, and the different axes the various aspects, motivations and implementation forms of the internationalization strategy. The speed at which a company moves is not necessarily the same along each axis; it depends on the internationalization strategy and the resources available whether it prefers to go one way or another.

Axis A—Impetus for international business: this could be a passive response to unsolicited orders, in which case the company would prefer countries representing low business risk, or it could be an active search for opportunities and higher levels of internationalization (and risk), which could be motivated by positive experiences derived from passive responses.

Figure 1.3 Patterns of international expansion



Source: Adapted from Daniels, J.D., Radebaugh, L.H. and Sullivan, D.P., *International Business—Environments and Operations*, 2005.

Axis B—Internal versus external handling of operations: at early stages of internationalization, companies usually rely on intermediaries who are well acquainted with the foreign market. As their success and experience grow, they may decide to take their foreign operations in their own hands.

Axis C—Mode of operations and commitment: as a rule, at the early stages of internationalization, companies opt for lower-risk operations such as exporting and importing. As they learn and become more confident about the foreign markets, they may go into a deeper level of commitment and assumption of risk, for example through licensing operations, joint ventures and foreign direct investment (FDI).

Axes D and E—Geographic diversification: at the beginning, companies will tend to internationalize operations into one or a few countries, preferably neighbouring countries or those belonging to the same regional or trade block and with close cultural and business affinities. At a later stage, operations can expand into a larger number of countries with diversified business environments and competitive conditions.

1.1.6 Foreign market entry strategies

In this section we will explore in more detail the various strategies used by companies to expand their operations into foreign markets. As mentioned above, they usually go in steps, in a way that minimizes risks, at least at the early stages of internationalization, and allows for deeper degrees of commitment as their learning and experience grow. Taking figure 1.3 as a reference, this is illustrated by axis C.

Except perhaps for the exporting activities, the various foreign market entry strategies result in the establishment of linkages with local producers in the targeted countries, providing them with opportunities for learning and thereby improving their capabilities and competitiveness and their ability to become internationalized themselves.

Attention to these aspects is one of the main purposes of this package. They will be given the relevance they deserve when we deal with the management of global operations and, in particular, with global value chains (GVCs) and global production networks (GPNs).

Exporting

Exporting is the simplest and least risky way for a company to start its global expansion. It can be done directly, when the company develops its own relationship with customers in foreign markets, for example by establishing sales offices in those markets; or it can be done indirectly, through international intermediaries.

On the one hand, direct exporting represents a deeper commitment and possibly higher risks than the use of intermediaries; but, on the other hand, it allows for faster learning about how to do business abroad, helps establish more productive relationships with customers and induces further internationalization and growth.

The use of intermediaries becomes necessary when a company is willing to export its products but has not sufficient experience of international business, is unable to find the

appropriate marketing channels, and has difficulty in identifying and targeting foreign customers. Intermediaries can provide the expertise and the range of services that are needed to bring to fruition the business relationship between the company and its foreign customers. These services by intermediaries in the foreign country may include:

- providing knowledge about the local market and competitive conditions and available sales networks;
- making business contacts on behalf of the company with local potential customers;
- evaluating the reliability and credit worthiness of local customers;
- providing transportation services and other necessary assistance in the field of distribution and logistics;
- handling official documentation and providing assistance in administrative and financing matters.

There are several different types of intermediaries, described in the following paragraphs

Export management companies (EMCs). These are firms that, because of their knowledge of the markets and expertise with export operations, provide international business services for manufacturing companies, either as international agents or as international distributors. As a rule, export management companies operate in focused geographic areas, particular countries they are acquainted with.

When operating as international agents, EMCs develop the business contacts abroad, the sales strategies and the export operations, and receive a commission based on the volume of sales.

As international distributors, the EMCs purchase the products from the manufacturing company and sell them in their own name, thus assuming greater risk but having the opportunity of taking greater profits.

Balancing the exporting option

FOR THE EXPORTER THERE ARE POSITIVE ASPECTS

- It is less risky and less complicated
- The costs are comparatively small
- The profits do not have to be shared

BUT THIS OPTION ALSO CARRIES SHORTCOMINGS

- It is difficult to control field operations
- Contact with customers is rare
- It does not allow for learning in markets

Export trading companies (ETCs). These are major intermediaries, operating on a large scale not only in geographical terms but also in the scope of their operations, which can include imports, exports, counter-trading, investments and manufacturing.

Historically, trading companies are associated to the European expansion overseas in the sixteenth century. Governments would give them exclusive trading rights against tax payments or royalties.

In modern times, the most common illustration of trading companies is the Japanese sogoshosha, which had a critical role in the internationalization of the Japanese manufacturing companies at the early stages of their expansion into foreign markets.

Other countries like Korea, Brazil and Turkey have also created trading companies, within their export promotion policies, as the operational arms of national companies willing to export their products. Even the United States has enacted legislation aimed at facilitating the creation of export trading companies in order to provide small and medium-sized enterprises with the proper intermediaries and services that would improve their export performance.

International licensing

Licensing can be an effective way for a company to expand its operations abroad and take advantage of the opportunities offered by foreign markets. Licensing represents a deeper level of commitment to internationalization, and also higher risks, as compared with export operations, but not the level of commitment or risk associated with foreign direct investment (FDI).

Broadly speaking, under a licensing agreement, the company, or licensor, allows a foreign firm, designated as licensee, to use its know-how and other intellectual property assets, like patents and trademarks, for the manufacturing and sale of the company's products. In exchange for the rights granted by the company, the licensee has to pay a compensation designated as a royalty, usually established as a percentage of the sales of the licensed products.

Pros and cons of licensing

THE POSITIVE SIDE

- No need of significant investment abroad
- Licensee takes most of the investment risk
- Allows for some control of field operations

THE SHORTCOMINGS

- Expected income depends on licensee
- Licensee becomes a potential competitor
- Risk of losing proprietary knowledge

The licensing agreement sets out the rights and obligations of both parties, for example the scope of the license, the technical assistance to be provided by the licensor to the licensee, if needed, the level of royalties the licensee is obliged to pay to the licensor, the duration of the contract, the countries where the licensee is allowed to sell the licensed products, the consequences of termination, etc.

All those aspects will be dealt with in detail in the chapters related to international negotiations and in those dealing with joint ventures. What is relevant in this section is the licensing option as a strategy to enter foreign markets and its main features as compared with other entry strategies.

With the licensing option, the company does not need to invest in the foreign country nor face problems associated with the regulatory environment there; it does not need to involve itself in costly market studies or worry about involvement with foreign customers. All these are tasks for the licensee to handle.

But there are also risks in licensing. The company will have to transfer to the licensee its manufacturing know-how and proprietary rights, which are the very foundations of its competitive advantage.

> As a rule, a licensing agreement is the result of a long and methodical process of confidence building; in many cases, the licensing agreement emerges as the result of a long-term relationship, mutual acquaintanceship and trust built up over years of shared commercial and export-related activities between the company and the licensee.

The licensee is a potential competitor in the future. An untrustworthy licensee could bring substantial damage to the company through unlawful use of the company's technology.

By the same token, when considering the licensing option, the company has to think about the legal and institutional environment in the foreign country with regard to such features as the intellectual property protection it provides and its contract laws, judicial practice and enforcement of contractual obligations, foreign exchange regulations and the assurance of timely remittance of royalties.

International franchising

In certain fields, franchising has been an effective way for companies to internationalize and expand their operations globally. In some respects, franchising may be regarded as a particular form of licensing, but in current business practice, licensing and franchising are substantially different and distinct concepts.

In a typical licensing agreement, the licensee manufactures a particular product based on the licensed technology, pays a royalty to the licensor for the rights granted under the licensing agreement and sells the licensed products according to its own managerial and marketing strategies. In other words, the licensee is, in principle, an already established company; the licensed product adds to the range of products manufactured by the licensee and does not necessarily change the configuration of the licensee's business.

In franchising, it is the whole business concept that is the subject of a franchising agreement whereby the owner of the concept, or franchisor, allows another company, or franchisee, to replicate that very kind of business according to the same concept, model, image and quality standard.

Classic fields where franchising has been widely used are fast food chains, hotel chains, car hire companies and retailing; but in recent years, franchising activities have become increasingly popular and have expanded into many business fields, big and small.

For the sake of illustration, let us take McDonald's or Kentucky Fried Chicken (KFC), in the field of fast food. The franchisee will have to:

(a) provide for the investment that is needed to set up the franchised business;
(b) adopt the franchisor's trade mark(s), logos, symbols, colours, architectural designs, staff uniforms, etc., which make the business instantly recognizable; and
(c) offer the same kind of products and the same way of delivering them as the franchisor, with a high degree of standardization and meeting similar quality requirements.

The franchisor, for its part, will provide the franchisee with the licenses which are required to use the know-how, trademarks and other proprietary elements; it will also make available to the franchisee all the technical assistance, training of personnel, product specifications, etc. that are needed to conduct the franchised business according to the required methods and standards.

Perspectives on franchising

THE POSITIVE SIDE

- No need of significant capital outflows
- Franchisee has knowledge of local market
- Allows for control of franchisee's operations

THE SHORTCOMINGS

- There is no direct contact with customers
- The profit has to be shared with the franchisee
- There may be potential problems in different cultures

Management contracts

Management contracts are used in situations where a company with experience in specific business areas or industrial sectors makes its personnel available to perform general or specialized management functions for another company.

In countries where effective managerial capacity in certain fields is scarce, management contracts are a viable way of accessing the necessary skills that would otherwise be difficult to find locally.

For the supplier companies, management contracts are a profitable way to expand internationally without the risks inherent in direct investment—and allow them to learn about the local environment and market opportunities for possible alternative ventures in the future.

As a rule, management contracts are concluded for periods of three to five years, and are subject to renewal. The remuneration for the supplier is comprised of two components: one a fixed fee, in principle commensurate with the services or personnel provided by the supplier, and the other based on volume or profit, which can be regarded as an incentive fee.

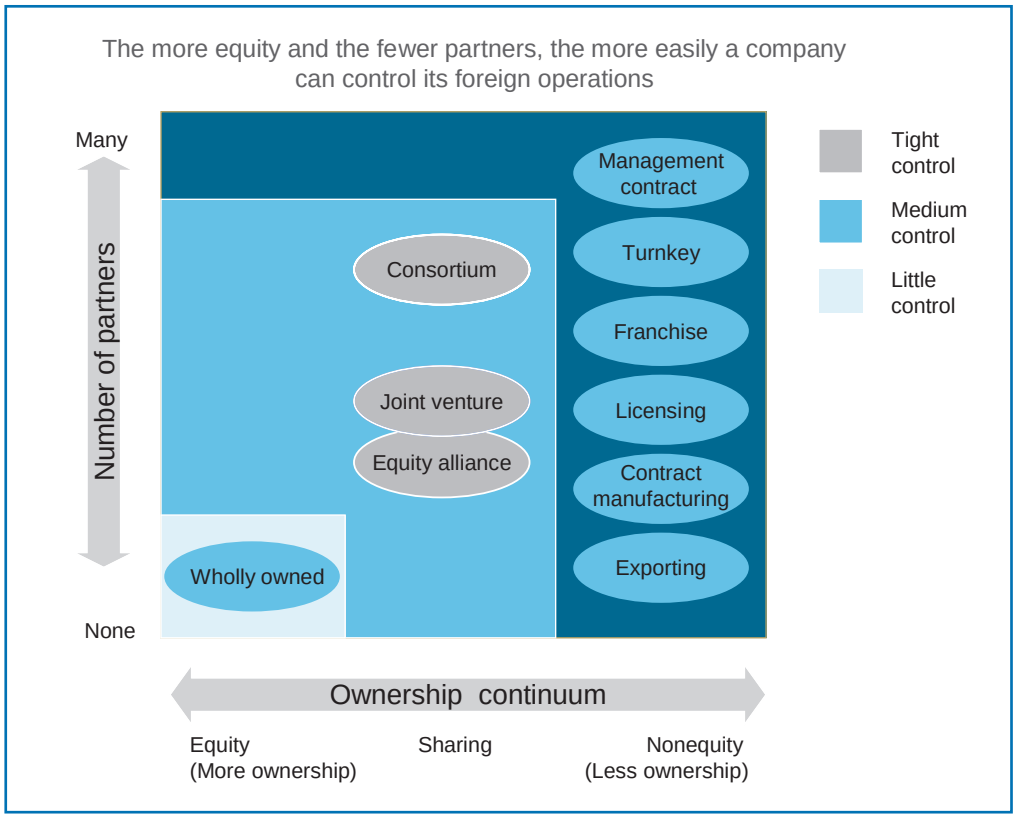
Management contracts are typically found in a number of fields, private or government-owned, where the patterns of competition (e.g. hotel operations) or the technical complexities (e.g., the management of an airport) require in-depth experience and expertise and a combination of skills that are not available to the owner of the facility.

Management contracts may also appear in turnkey operations; these will be described in the next section.

Two additional points about management contracts may be mentioned here:

(a) Developing countries which need to resort to management contracts should value them as an opportunity for learning so that, over a period of time, local capacities can be built up and the managerial functions assigned to the supplier can be partially or totally phased out; the mechanisms for learning and the timing of the phasing out can be the subject of appropriate provisions in the management contract.

Figure 1.4 Control complexity related to collaborative strategy



Source: Adapted from Daniels, J.D., Radebaugh, L.H. and Sullivan, D.P., *International Business: Environments and Operations*, 2005.

(b) In some fields, as illustrated by the case of hotel operations, the management contracts may resemble a franchising situation in as much as they involve distinctive business models with a globally recognizable branding associated to them. The difference between the two is that in a franchising contract the facility is managed by the franchisee as the owner of the franchised facility, while in a management contract the management of the facility is external to the owner, i.e. it is provided by the supplier's expatriated personnel.

Turnkey operations

Turnkey contracts apply to a form of international operation, often involving large-scale complex projects, which may provide opportunities for smaller firms of the host country to serve as subcontractors and suppliers.

In a turnkey contract, one client company contracts another company to build and deliver a ready-to-operate industrial plant or infrastructure facility, such as a power plant, a highway or a port, where the client can be a government agency.

There are various reasons why turnkey contracts represent the preferred option for the client, as compared to other project implementation modalities, for example the client itself taking responsibility for the coordination and management of the project activities.

Industrial or infrastructure projects are complex undertakings, the implementation of which involves the mobilization and articulation of many different disciplines and a variety of suppliers. These may include various engineering branches (mechanical, electrical, civil), the manufacturing and supply of equipment, management of the project implementation activities and commissioning and start-up operations.

Reasons for turnkey contracts

- The client lacks project management capabilities to implement complex projects.
- The contractor takes responsibility for the coordination of the overall project.
- The client avoids the risk of delays, cost overruns and performance failures.

With a turnkey contract, the risks associated to possible delays, defective deliveries from different suppliers, cost overruns and performance failures are born by the turnkey contractor.

The usual turnkey contractors are construction companies, industrial-equipment manufacturers and engineering and consulting firms who assemble and coordinate the other players and take responsibility for the overall project.

The turnkey operations conducted in developing countries provide an opportunity for local firms to act as subcontractors in areas where local competencies may be available, for example selected engineering tasks, the manufacturing of non-proprietary

equipments and metal structures, civil works, etc. Furthermore, the linkage of local firms with international turnkey contractors will contribute to leveraging their capabilities and pave the way for their own internationalization.

Some turnkey operations are also associated with or lead to management contracts. This could be the case when the client has the plant or the infrastructure facility built and commissioned under a turnkey contract but then needs to enter a management contract to acquire the skills for the operation and maintenance, at least until local capabilities can be built up and made available.

Equity alliances[9]

This training package revolves around the issues related to international business and inter-enterprise collaboration arrangements at the global level, which are currently designated as "joint ventures", "collaborative agreements", "international alliances", "strategic alliances" and so on. Sometimes these terms are used in a generic way and interchangeably, but they may also carry a specific meaning and a sharper characterization, which will be clarified throughout the package whenever needed.

There are many reasons why firms collaborate, for example to gain market knowledge and benefit from the distribution potential of a local firm, to access other companies' technological capabilities, and to share costs and risks in forward-looking research and development programmes. A more exhaustive picture will emerge in part 2, mostly focusing on strategic alliances and joint ventures.

Features of equity alliances

- Equity alliances usually take the form of minority equity ownership
- Range from loosely bound relations to well-structured agreements
- Investors seek collaboration on design, engineering and markets

Inter-firm collaboration arrangements can range from loosely organized alliances to tightly structured contractual agreements as, is the case in joint ventures.

In this context, we can refer to equity alliances as a form of collaborative arrangement in which at least one of the collaborating companies takes an ownership position in the partner company; in some cases, each party takes an ownership of the other party, for example by buying part of each other's shares or by swapping some shares with each other.[10] Typical equity alliances are to be found in the automotive industry, but they also appear in other industries, from electronics to the airline industry. Through equity alliances, and even in cases of minority ownership (which are usual), multinational enterprises seek a certain measure of control of companies that are important to them for, for example, sharing designs, engineering and parts; ease of market entry; and the development of new products and systems. One motivation for equity alliances may also be the desire to solidify other inter-firm

[9] *See* Reading Materials, *Equity Alliances.*
[10] Daniels, John D., 2004.

collaboration arrangements, such as supplier-buyer contracts, which are more difficult to break within the framework of an equity alliance, particularly when the ownership is large enough to secure a management position in the partner company. In a generic sense, equity alliances could be regarded as a particular form of joint venture; but as we will see below, when we focus on the concept of equity joint ventures, these are substantially differentiated entities (*see* Reading Materials, case of Porsche vs. Volkswagen).

Joint ventures

The term "joint venture" is not used consistently in international business practices. Essentially, the term "venture" means an undertaking involving chance, risk or danger, and the term "joint venture" means a "joint undertaking", and parties in international business transactions tend to describe different kinds of joint efforts to achieve a common aim as a "joint venture", which then appears as synonymous with other kinds of collaborative agreements; for example, the concept of equity alliance presented in the previous section could fit this broad definition.

The "joint ventures" which are the subject of our study are of a specific character, and will be given in-depth treatment in part 2 of this package; the purpose of this section is simply to present some of the key features of the joint venture option as a form of foreign market entry strategy.

A joint venture is the long-term participation of two or more companies in an enterprise in which each party contributes assets, has equity participation, and shares risk. Sometimes parties do not even provide a time limit for the duration of their contracts, the assumption under which they are established being that they will jointly run the undertaking for as long as the venture is viable.

There are different reasons for international companies to establish joint ventures in developing countries, such as:

- the interest of the foreign investors in minimizing capital outlays or entry risks by using the local partners' assets;
- their inadequate knowledge of the local institutional and legal environment and access to local borrowing, and the goodwill associated to the perception that the joint venture is a local company, etc.;
- in specific sectors, particularly strategic sectors, the country's laws may not allow full ownership of operations by foreign nationals.

Perspectives on joint ventures

FOR THE PARTNERS

- Common vision and objectives
- Synergies and complementarities
- Shared risks and mutual benefits
- Intended long-term collaboration

FOR GOVERNMENTS

- Access to technology and skills
- Development of local industry
- Promotion of trade and exports
- Job creation and economic growth

Local partners, for their part, may be motivated to take advantage of the association with the foreign partner to access their technology, international brands, product development and managerial techniques.

Joint ventures, in the sense given to the term in this work, usually imply the creation of a new legal entity by the incorporation of the partnership established through the joint venture agreement. The new incorporated body has an existence of its own and is sometimes called an "incorporated joint venture" or an "equity joint venture", in contrast to the "contractual joint ventures" or "consortia" which are described in the next section.

Moreover, the joint venture agreement very often consists of a "package" of various contracts, for example transfer of technology contracts and various other types of supply and service contracts, which are usually associated to the formation of an incorporated joint venture. The joint venture agreement also sets the rules that govern the managerial issues, as we will see in part 2.

Consortia (or consortiums)

In some sources,[11] consortia or consortiums are identified as "joint ventures where more than two organizations participate", and in the classic literature we often find the term "contractual joint ventures" as another way of designating consortia. But in a more currently accepted concept, the term consortium is used to designate short- to medium-term alliances which are set up to implement time-limited projects.

Illustrative cases of consortia

- For infrastructure projects needing the articulation of different contractors
- For costly research and development projects, e.g. in pharmaceuticals
- In the aircraft industry, European-wide projects, e.g. Airbus consortium

Typical cases of consortia appear in the field of civil engineering, and in the construction, building and equipment supply industries, where contractors decide to join their forces for a limited period of time in order to jointly build a plant or an infrastructure facility. The channel tunnel between Britain and France was built by a number of construction companies which formed a consortium called Trans Manche Link (TML). The consortium was dissolved on completion of the project.

Consortia are also found in industries where the high costs and risks associated to research and development work lead multiple companies to form partnerships in order to achieve a common objective, for example in the pharmaceutical industry, where a new drug can cost $US800 million to develop and bring to market; in the aircraft industry, the formation of the Airbus Industries consortium for the European production of commercial jets; and in information and communication technologies, the formation of consortia for the creation of new generations of computer chips or the development of advanced wireless communication systems.

[11] For example, Daniels, 2004.

Contract manufacturing

Contract manufacturing can be included among the forms of market entry strategy that we have been enumerating; it can also be regarded as a modality of outsourcing, which will be presented in chapter 2, which is devoted to the manufacturing strategies of MNEs.

(a) *As a market entry strategy:* In contract manufacturing, a company willing to enter a foreign market can contract a domestic enterprise to manufacture a product intended to be sold locally. In this way, the contracting company will not need to set up its own facilities in the targeted country, thus avoiding the burden and risks of investment; however, it can keep control of its product and technology through the provisions of the contract and through the supply of the product specifications and other inputs, such as materials, components and technical assistance.

Highlights of contract manufacturing
(contractor's perspective)

THE POSITIVE SIDE

- No need of investment in own facilities
- Advantage of lower manufacturing costs
- Control of product and technology

THE SHORTCOMINGS

- Manpower may lack proper qualifications
- Required quality standards may not be easy to achieve by the manufacturer

As an example,[12] in 2002, in a bid to get a footing in the potentially vast auto market in China, Toyota entered an agreement with China's First Automotive (FAW) aiming at the local production of a number of car models. Toyota, which would have no equity participation, would contribute with management expertise, technology, marketing assistance and cash, while FAW would provide manpower, factories and equipment.

(b) *As a form of outsourcing:* As an element of their global manufacturing strategies, MNEs widely use contract manufacturing as a form of outsourcing components, systems and products which they design, have assembled or manufactured by a contract manufacturer, and sell on a global scale.

Many Asian firms have prospered as contract manufacturers, most visibly in the fields of information technology and consumer electronics. In the process, through their own learning and innovation efforts, many of them are becoming "original design manufacturers" (ODMs) and "original brand manufacturers" (OBMs), in a pattern of development and internationalization that will be further highlighted in chapter 2.

[12]Czinkota, Ronkainen and Moffet, 2004.

For the sake of illustration, we can take the case of Flextronics, the world's biggest contract manufacturer. It has 20,000 employees and 2.5 million square feet of manufacturing capacity in Malaysia. It makes Sony Ericsson handsets, Hewlett-Packard printers, Xerox copiers, and products for dozens of other companies. Flextronics has 7,000 of its staff engaged in R&D activities, following a trend that is common to other contract manufacturers which aim at affirming themselves as ODMs and OBMs.

Full ownership: wholly owned subsidiaries

A reference to wholly owned subsidiaries is warranted here for the sake of comprehensiveness in the enumeration and characterization of the foreign market entry strategies of multinational enterprises.

As we have seen in section 1.1. the traditional strategies of foreign direct investment operations (FDI) of multinational enterprises (MNEs) involve wholly owned subsidiaries directly linked to the headquarters.

Such structures may still be found in business fields where the total control of subsidiaries' business is a strong requisite for a number of possible reasons: to protect intellectual property; because of a deeply rooted corporate culture; or because headquarters control is critical to the success of international marketing activities. However, as also explained above, the current trend is against full ownership by MNEs in their FDI operations. Among the factors supporting this trend we can mention the risks inherent to legal restrictions in host countries; the volatility in the political or economic environment; and the fact that, in the context of international competition, on the one hand, and liberalization and globalization of markets, on the other, MNEs increasingly resort to less risky and more beneficial outsourcing within coordinated global value chains and production networks.

The case of "born global" firms[13]

The concept "born global" was first introduced in a survey for the Australian Manufacturing Council by the consultants McKinsey & Co. The survey showed that two main types of exporters could be identified:

(a) firms that had built a solid base in the home market over the years and had been driven to exports as a strategy for growth according to the classic patterns of multinational expansion; and

(b) firms that were export oriented practically since their foundation, as though as they "view the world as their market place from the outset and see the domestic market as a support for their international business". (Mckinsey & Co., 1993, p.9).[14] These are the "born global" firms.

A distinctive feature of "born global" firms is that they do not follow the traditional approach of achieving internationalization by incremental stages. On the contrary, they have the ability to address their products and services to the global market almost from their birth.

[13] *See also* Reading Materials, *Born Global Firms*.
[14] *Source:* Rasmussen, E. S., and Madsen, T. K., 2002.

Many "born global" firms are small and medium-sized enterprises. They are found in different sectors, including high-tech fields, and are typically directed to international niche markets.

An explanation for this emerging behaviour seems to be the pervading flows of information, the increasing number of people with international experience, and the global market conditions with a growing number of international networks and niche markets.

> Empirical studies have shown that many born global firms become global exporters from the start because of the international experience of their founders or because of the management's commitment to internationalization.

Before the born global concept was introduced, other authors had documented the existence of firms which were internationally oriented right from their birth, and used different terms to describe them.[15] Examples of these are:

(a) *High technology start-ups* (Jolly et al., 1992). "The main characteristic of these firms is that their founders came from several different countries and followed a strategy directed towards international niche markets. As developers of high tech products, these firms have a natural vocation to be international right from the beginning.

(b) *International new ventures* (Oviatt and McDougall, 1994). These are regarded as business organizations that, from their inception, seek to derive significant competitive advantage from the use of resources and the sale of outputs in multiple countries. This category includes:

- *(i)* firms that operate both as exporters and importers (new international market traders);
- *(ii)* firms that gain their competitive advantage by servicing a few customers with a highly specialized demand in a relatively small part of the world (geographically focused start-ups); and
- *(iii)* firms that are active both in reacting to the opportunities to place their products in the global markets and in accessing resources from multiple countries.

Review of chapter 1.1

Overview of international business

The strategies and forms of international business have continuously evolved in the last few decades as a result of continuing progress in technology, the liberalization of investment flows, and increased competition among enterprises. Nowadays, enterprises tend to operate within complex networks and with an increasing use of outsourcing.

[15] *Source:* Rasmussen and Madsen, *op. cit.*

Enterprises involved in international business have been referred to in different ways, for example transnational corporations, global corporations, multinational enterprises, and so on. Sometimes the terms are intended to designate a specific type of operation, or strategic approach, but often such terms are used interchangeably.

Several specific factors drive enterprises to seek business development and growth through international and global operations, namely

(a) market opportunities,
(b) increased development costs and need for economies of scale,
(c) pressure of competition, and
(d) a more open business environment.

Globalization as a business strategy is not exclusive to enterprises with a traditional international vocation. Many small and medium-sized enterprises also go global nowadays for a variety of reasons, which can be categorized as proactive motivations and reactive motivations

Proactive motivations are the reasons why firms positively want to go global, for example where they feel they have a competitive advantage or sense opportunities abroad.

Reactive motivations are where firms decide to enter foreign markets as a reaction to factors at home, for example to overcome competitive pressure or a declining home market, or to find outlets for overproduction.

Foreign markets, as compared to domestic markets, usually involve significant differences in various areas that companies have to consider, mainly in political, social and cultural factors; local and related international laws; geography and natural conditions; and infrastructure and manpower.

As a rule, at the early stages of internationalization, companies opt for lower-risk operations, such as exporting and importing. As they learn and become more confident about the foreign markets, they may enter a deeper level of commitment and assumption of risk, for example through licensing operations, joint ventures and subsidiaries.

Export intermediaries can be international agents (working for a commission) or international distributors (purchasing the products to sell them in their own name). Intermediaries can provide the expertise and the range of services that are needed to bring to fruition the business relationship between the company and its foreign customers.

Under a licensing agreement, the licensor allows the licensee to use its know-how and other intellectual property assets for the manufacture and sale of a product. As a rule, a licensing agreement results from a long process of confidence-building between licensor and licensee; in many cases, it emanates from a previous business relationship.

In a franchising agreement, the franchisee is allowed to adopt and replicate a certain business concept, model image and standards owned by the franchisor. The franchisee will have to invest in setting up the franchised business but will benefit from a well-established brand and from the franchisor's assistance.

Management contracts are a profitable way for international expansion without the risks that are usually associated to direct investment. For some developing countries, management contracts represent a viable means of accessing necessary skills that would otherwise be difficult to find locally.

In a turnkey contract, one client company contracts another company to build and deliver a ready-to-operate industrial plant or infrastructure facility. Some turnkey operations are associated to or lead to management contracts, for example when the client needs to outsource the skills for the operation and maintenance of the plant.

Equity alliances usually take the form of minority equity ownership, sometimes also involving equity swaps between the firms. They solidify other forms of inter-firm collaboration arrangements, such as joint research and development or supplier-buyer contracts for engineering and parts.

Essentially, the term joint venture means any undertaking though which the parties join efforts to achieve a common aim; but the term also carries a more specific meaning, namely a long-term association of two or more companies which contribute with assets to the creation of a new legal entity—the joint venture company.

Consortia are short- or medium-term arrangements involving various companies that decide to join forces to implement a project; upon project completion, the consortium is dissolved. Consortia can be found in infrastructure projects or in projects involving costly investments in research and development

Contract manufacturing can be regarded as a form of market entry strategy or a modality of outsourcing used by MNEs as element of their global manufacturing strategies. Through their own learning and innovation efforts, many contract manufacturers have improved their capabilities and become "original design manufacturers" and "original brand manufacturers".

Born global firms do not follow the traditional approach to internationalization by incremental stages; they are typically export-oriented since their foundation. The increasing number of people with international experience, and the spread of international networks and niche markets all over the world explain the emergence of born global firms.

1.2 Global manufacturing strategies of MNEs

1.2.1 The drivers of changing strategies

The opportunities for developing countries' firms to achieve internationalization are very much dependant on the dynamics of international business and, in particular, on the business strategies of multinational enterprises (MNEs). With that in mind, this section will analyze the approaches taken by multinational enterprises (MNEs) in the management of their global manufacturing operations, the changing patterns of their behaviour and the underlying drivers of change, and the implications for developing countries at the enterprise and policymaking levels.

(a) *Technology, innovation and competition for markets.*[16] Technology is a critical source of competitive advantage; a problem for companies is to keep innovating all the time in order to stay ahead of competitors or otherwise lose their position in the marketplace. "Innovate or die" is not just a metaphor; it is a reality of today's business environment. It is disturbing to think that, of the top names in the Fortune 500 list for 1985, less than half were still there by 1995.[17] For smaller firms, the death rate is still higher. At the time of working on this package, we heard that Polaroid, which once amazed the world with its instant photo technology, was unable to survive the assault of digital photography and may eventually fade into oblivion. On the other hand, Kodak, a long time leader as a conventional camera and film maker and also facing the threat of digital technology, managed to react to it successfully by decisively going digital and entering the lucrative printing business, reversing its declining fortunes to become the US market leader in the field of digital photography.

In order to survive the competitive pressures and to grow, firms resort to cost-reduction strategies, for example subcontracting, contract manufacturing, outsourcing materials and other inputs, or taking advantage of locational benefits; but, most of all, they have to invest substantially in R&D and innovation. Sometimes they do so with their own resources, which brings them ownership of the technology developed, and consequent market dominance; in other cases, they do it in association with other firms, even with competitors, when the development costs are too high and the outcome too uncertain for one organization to risk taking on alone; another approach, a growing trend in the practice of multinational enterprises, is to outsource innovation, either subcontracting R&D to suit their product development targets or adopting new products developed by other firms and commercializing them under their own brands.

The evolving routes for innovation

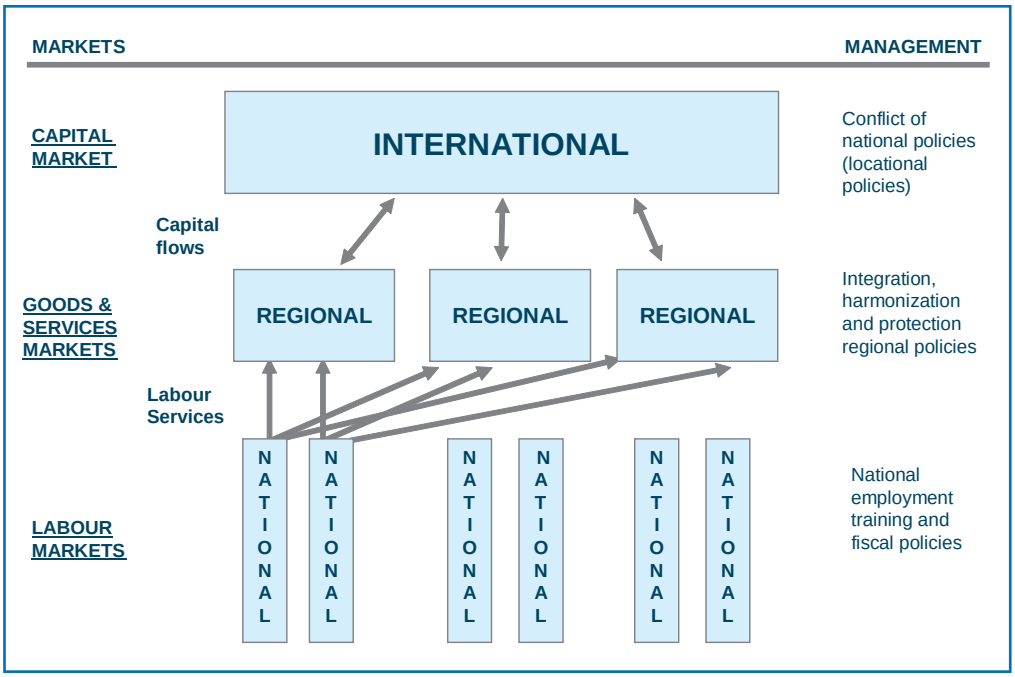
- *Traditional:* Inside the firm with own resources aiming at market leadership
- *Current situation:* In cooperation with other firms because of costs and risks
- *Ongoing trend:* Outsourcing innovation from dynamic firms in order to stay ahead and to shorten time to market

[16] *See* Reading Materials, *Competition: coping with the "China factor."*
[17] Brown, Lamming, Bessant and Jones, *Strategic Operations Management*.

(b) *The conflict of markets.* As illustrated in figure 1.5, there are three types of markets with substantially different characteristics and moving at different rates, entailing deep consequences for MNEs strategies. At the top of the diagram, a single block represents the capital market, which is very closely integrated (capital has a high mobility as compared to other production factors); in the middle are the regional markets for goods and services (e.g. regional blocks such as EU and NAFTA); and, at the bottom, the labour markets, which are essentially national and immobile. These are markets that move at different rates, as does the globalization process.

The implications for MNEs strategies are that they can raise capital at the lowest possible cost and disburse it wherever they like; they can gain economies of scale in goods and services markets and thus achieve long production runs and reduce costs within key markets; they also have the opportunity to place their labour-intensive stages of production in labour markets that provide both cheap costs of labour in relation to productivity and flexibility of operations.

Figure 1.5 Conflict of markets drives internationalization of firms



Source: P. Buckley, 2003.

(c) *Volatility of the world economy.* The world economy is uncertain, and, increasingly, interconnected events or crises in one place may have immediate reverberations on a global scale. This volatility is one of the major reasons for MNEs' changing strategies. Their reaction to this volatility is to build as much flexibility into their operations as possible. There are two key areas where flexibility is essential.

One is the locational strategy. In order to minimize risks, MNEs avoid concentration of their offshoring, foreign investment operations or outsourcing in a single country; by the same token, they can easily move from one location to another

according to changing conditions and perceived comparative advantages. This is true not only for MNEs investments in developing countries but also for their operations in industrialized countries.[18]

The other is ownership strategy. The traditional hierarchical, vertically integrated multinational enterprise is giving way to a much more network-like firm. Instead of foreign direct investment through wholly owned subsidiaries, MNEs increasingly operate abroad through other forms of collaboration, such as joint ventures, subcontracting, licensing, or other kinds of non-equity arrangements.

(d) *Liberalization policies in developing countries and competition for FDI.* Since the early 1980s, a trend has emerged in developing countries to abandon the former import-substitution regimes and increasingly adopt liberalization policies on the investment and trade operations of multinational enterprises (MNEs). On the one hand, the liberalization trend was induced by the pressure of multilateral trade negotiations as well as regional and bilateral trade agreements linking developing countries to industrialized countries. The conditions associated to structural adjustment programmes supported by international financial institutions also compelled the adoption of liberalization policies in countries that entered into such programmes. On the other hand, this trend also resulted from the recognition of the positive correlation between foreign direct investment (FDI) and growth.

The perceived advantages of FDI led governments of developing countries to compete among themselves to attract foreign investors. This is certainly a major element in the locational flexibility enjoyed by MNEs in their global operations.

Drivers of MNEs' changing strategies

- Technological change, innovation and competition for markets
- Conflict of markets: capital vs. labour and regional bocks
- Liberalization policies in developing countries; competition for FDI
- Advances in information and communication technologies

(e) *Advances in information and communication technologies.* The technology advances in information and communication technologies are another important driver of MNEs' changing strategies by allowing the management and control of their global supply chains, manufacturing, warehousing and distribution operations, and networks of suppliers, subcontractors and subsidiaries. Different mechanisms have been developed, for example electronic data interchange (EDI) to link suppliers, manufacturers, customers and intermediaries; call centres and e-commerce to process orders and serve customers on a world-wide basis; and the extranet to link companies with their suppliers and subcontractors so that they can organize production and deliver their inputs when needed. Multinational enterprises and software developers alike have been actively implementing information technology packages and putting them to

[18] *See* Reading Materials, *Locational Strategies of MNEs*.

use to manage their operations over the Internet. The latest trend is that of private technology exchange (PTX), which allows online collaboration, as well as time and cost reductions, among the elements of value chains and production networks.

Example: Walmart has 14,000 suppliers throughout the world connected to its inventory ordering system who process transactions worth more than $US217 billion. One could ask whether such a business could be implemented without the information and communication tools that have come into being with the technology revolution of the past two decades.

Source: Daniels, J. D., Radebaugh, L. H., and Sullivan, D. P., 2004.

1.2.2 Implications for MNEs' operations

The operational strategies of multinational enterprises, which policy makers of developing countries have to dissect and understand, are influenced and shaped by several interrelated elements. First, the intense competition for consumers' preference and market position, which means continuing innovation, differentiation, improvement in product quality, and also lowering of prices; second, the liberalization of trade and FDI regimes, which results in decreasing transaction costs and gives MNEs substantial flexibility in the spatial location of their operations and in the dynamic distribution and redistribution of manufacturing and services according to convenience; third, the mobility of capital and the propensity of MNEs to shift from more "closed" and vertically integrated operations to more "open" structures where the outsourcing and offshoring of non-core operations is becoming the prevailing rule; fourth, the advances in information and communication technologies, which give MNEs the tools and skills to process data and the ability to effectively coordinate and manage complex networks of suppliers and customers worldwide, and thus to respond quickly and flexibly to changes in demand and to play to their advantage with locational differences in costs, infrastructure, manufacturing capabilities, and trade and investment regimes. Furthermore, this scenario has made possible the fragmentation of manufacturing activities. The following sections will analyze in more detail the way MNEs organize and manage their global operations.

Vertical integration, insourcing, offshoring and outsourcing; subcontracting and contract manufacturing

Under the pressure of competition, and with the flexibility that results from the openness of developing countries to trade and investment flows and the coordination and control possibilities that are offered by the advances in information and communication technologies, multinational enterprises (MNEs) can organize their operations in ways that better suit their interests and strategies.

Vertical integration used to be the traditional approach to companies' operations. It is characterized by ownership of the entire production and supply chain, including the research and development (R&D) activities, seen as intrinsic to the company's culture and core capabilities. Vertical integration has the advantage of allowing for the

Alternative operations strategies

- *Vertical integration*—own supply; ownership of the entire production and supply chain
- *Insourcing*—supply through shared service centres established within the company
- *Offshoring*—moving operations abroad as a strategy to minimize manufacturing costs
- *Outsourcing*—third party supply of inputs, e.g. services, components or products

consolidation of all processes for a specific product or product line, but it also involves risks and shortcomings which, in the present conditions of competition, companies' may not wish to take. One risk is that vertically integrated manufacturing facilities may have difficulty in coping with changes in demand, quantitative or qualitative, with consequent missed opportunities or financial losses. A further shortcoming of vertical integration is the possibility that many of the elements of a production and supply chain can be obtained in better quality and at a better price from outside sources, which also explains why enterprises increasingly resort to offshoring and outsourcing operations.

Insourcing: is a step between vertical integration and outsourcing. It consists of establishing shared service centres within a company so that different areas of business can benefit from such services in an efficient, streamlined, standardized and cost-effective way. With the insourcing approach, companies achieve efficiency gains by relocating and concentrating resources in one specific structure that otherwise would be disperse, uncoordinated and inefficient; skills can be retained and assets exploited, resulting in lower unit costs for the insourcing business.

There are cases of companies' activities that, through the in-sourcing approach, became viable business units that evolved into self-sufficient independent firms with an international out-reach.

Offshoring: literally speaking, offshoring means to move a business process to a foreign location. Offshoring became attractive as a cost minimization strategy for MNEs; they set up production facilities in foreign countries, for example in Asia, Mexico, and Eastern Europe, to take advantage of low labour costs, availability of cheap materials and components, and proximity to markets. Offshore manufacturing became popular in the 1960s and 1970s in the electronics industry, when western companies, one after another, set up facilities in Asian countries, namely in Taiwan Province of China, South Korea and Singapore. Subsequently, as wages rose in those countries, offshore manufacturing shifted to lower-cost countries, for example China, Indonesia, Malaysia, Thailand and Vietnam. Offshoring, as characterized above, can be regarded as synonymous with foreign direct investment (FDI), but can also be perceived as a form of outsourcing, which is the case when the offshored elements are provided by independent firms.

Offshoring and outsourcing benefits

- Provides cost reduction of product or service
- Allows for access to technology and innovation
- The company can concentrate on core business
- The company gains more flexibility in its operations

Outsourcing can be defined as a way of having inputs supplied to a firm by a third party. Outsourced inputs can vary greatly, for example call centres, human resources services, inventory management, inventory control, the supply of components or the provision of full-scale manufactured products. Through outsourcing, a company or organization can concentrate on what it does best and also take advantage of the expertise that the provider has accumulated and will possibly keep improving.

A decision to outsource has to balance both economic and strategic considerations, such as:

- the costs of outsourced products vs. in-house production;
- the quality and reliability of supplies from outside sources;
- its capability (or lack of it) for in-house production;
- vulnerability resulting from possible supplier coalition;
- the loss of intellectual property and innovative capabilities;
- the danger of suppliers becoming competitors.

Too much or too little vertical integration can result in competitive disadvantages, so this decision should be addressed from a strategic perspective.

Outsourcing is not only sought by big companies; small businesses are also increasingly turning to outsourcing for a variety of reasons: in some cases, it is the question of cutting prices and surviving the competition pressure; in others, it is to find the skills that are needed but not available in-house, for example software programming, graphic design and advertising. Small businesses may also find outsourcing attractive because of the flexibility it provides. With a relatively small staff, they can quickly expand in periods of peak work by sending orders overseas, and shrink again in the off-season.

It should be pointed out that not all outsourcing experiences are successful, particularly when the client is a small business, located far away from the outsourcer, without an on-site manager, and possibly facing substantial time differences and language barriers, as could be the case if one is in the United States and the other one in India.

Big companies may also perceive potential problems with outsourcing. Loss of operational control has been found to be one of the biggest concerns. Cultural barriers and long-term dependency may also be regarded as potential problems that companies have to take into account when taking a “make or buy” decision.

Subcontracting; contract manufacturing. In section 1.5 we have already introduced the concept of contract manufacturing as a modality of outsourcing whereby a company has components, systems or products of its own design assembled or manufactured by another company, usually referred to as a contract manufacturer.

Subcontracting is also a form of outsourcing and the concept can currently be regarded as practically the same as contract manufacturing. Some subtle distinction between both concepts is rooted in the historical development of outsourcing activities. At earlier stages, the term subcontracting was used more in the outsourcing of simpler operations or the manufacturing of components according to the requirements of the main contractor.

The term contract manufacturing has a stronger connotation with the outsourcing (or "subcontracting") of more complex systems or equipments, where the manufacturer is required to have a higher level of expertise and, in some cases, also design capabilities.

According to UNIDO, subcontracting can be defined as:

An economic relationship where one entity, the main contractor, requests another independent entity, the subcontractor or supplier, to undertake the production or carry out the processing of a material, component, part, sub-assembly, or the provision of an industrial service in accordance with the main contractor's specifications.

Source: UNIDO, *International Subcontracting versus Delocalization,* 2003.

The growth of industrial subcontracting has led to the development of two main types of subcontracting relationships:

(a) *Capacity subcontracting.* This corresponds to the more traditional concept. Here, the main reason for subcontracting is the fact that the main contractor does not have enough capacity to undertake the manufacturing of the specific component, part or material. In other words, the main contractor has reached the capacity limit of its production process and, in order to meet the market demand for its product, is required to refer to a subcontracting specialist, at least for a temporary period.

(b) *Specialist subcontracting.* This modality practically corresponds to the concept of contract manufacturing. In this case, the main contractor relies upon the services of a subcontractor who has specialized equipment or machinery and skilled labour to undertake complex and precision tasks. These may involve either finished products or specialized components or supplies that require a higher level of technical expertise than that which the main contractor possesses or can meet.

Outsourcing innovation is becoming a trend that shows how far MNEs' strategies are evolving in their search for external sources of competitive advantage. Innovation is outsourced not only through research contracts but also by acquiring complete designs from the dynamic innovative firms in Asia and simply commercializing the devices under the outsourcing companies' brand names. This is becoming common with brands like Dell, Motorola and Philips, and for equipments ranging from laptops and high-

definition TVs to MP3 music players and digital cameras. While this trend is more conspicuous in the electronics sector, outsourcing and off-shoring innovation is spreading into many other fields of the economy. Just a few examples will illustrate this: in early 2005, Boeing entered a deal with HCL Technologies of India to develop critical software for the operation and navigation of the 7E7 Dreamliner jet; leading pharmaceutical companies like GlaxoSmithKline and Eli Lilly are involving Asian biotech companies in joint research activities in order to cut the extremely high costs of bringing new drugs to the market; and Procter and Gamble intends to increase the contribution of outsourcing and offshoring (now at the level of 20 per cent) to creating new product ideas.

1.2.3 Global supply chains, global value chains and global production networks

The concept of supply chains and value chains

An overview of major textbooks and academic literature has shown that the terms "supply chain" and "value chain" are used interchangeably and with practically the same meaning. In some works we only find one of the terms and not the other; in other works we find both terms but without a clear elucidation of the distinction between the underlying concepts. The book *International Business*,[19] for example, gives the following definitions in its glossary:

Supply chain: The coordination of materials, information and funds, from the initial raw material supplier to the ultimate customer.

Value chain: The collective activities that occur as a product moves from raw materials through production to final distribution.

These definitions do not provide much help if we are looking for a distinction between the terms, which in fact exists and is highlighted by some sources and authors.[20] According to them, we can differentiate the concepts of supply chain and value chain as follows:

Supply chain encompasses all the activities associated with the flow and transformation of goods from the raw material stage through to end users, as well as the associated

Supply chains and value chains

- *Supply chains:* flow of all firms' activities from extraction of raw materials and their transformation to final distribution of goods
- *Value chains:* the supply chain involves a sequence of "value activities" by the firm that create a product of value to customers

[19]Daniels, John D., Radebaugh, Lee H., Sullivan, Daniel P., *International Business*, Pearson Prentice Hall, 2004.

[20]For example, Kauffman, Ralph G., *A Best-practice Approach to Transforming Global Supply Chains*, 89th Annual International Supply Management Conference, April 2004.

information flows. It includes systems management, operations and assembly, purchasing, production scheduling, order processing, inventory management, transportation, ware-housing and customer service.[21] (In a way, this concept embraces both the above definitions of supply chain and value chain).

Value chain is a concept introduced by Porter (1985)[22] to underscore the idea that every business is a collection of activities to design, produce, market, deliver and support its product in a sequence that he terms "value chain". The activities are called "value activities" and through them the firm creates a product of value to its customers. In monetary terms, the total value of a product to customers is higher than the total cost of the value activities and the difference represents a higher profit margin to the firm and a lower cost for the customers.

To underscore the conceptual distinction between supply chain and value chain, we can say that when talking of supply chain we are thinking of the flow and processing of physical inputs along the chain, and when talking of value chain the underlying idea is that at each node of the chain we have outputs which, in accounting terms, bring an added value to the manufacturer.

Figure 1.6 illustrates a typical supply chain network for a manufacturing or service organization.[23] It shows three interrelated levels of intervention:

(a) the material management functions of receiving and storing the raw materials and components, the processing and manufacturing functions, and distribution and delivery to customers;
(b) decision-making functions and related information-processing functions, including orders from customers, orders to suppliers, and the planning and control process; and
(c) functions related to the transfer of funds, which have to be assumed as a form of working capital and have to be regarded as an important element in the supply chain.

The need for supply chains, whether through vertical integration, offshoring, outsourcing, purchasing or a combination thereof, is inherent to any firm. The problem firms face is how to transform supply chains into value chains, which means meeting or exceeding the customer's expectations at the lowest cost and achieving success in terms of profitability.

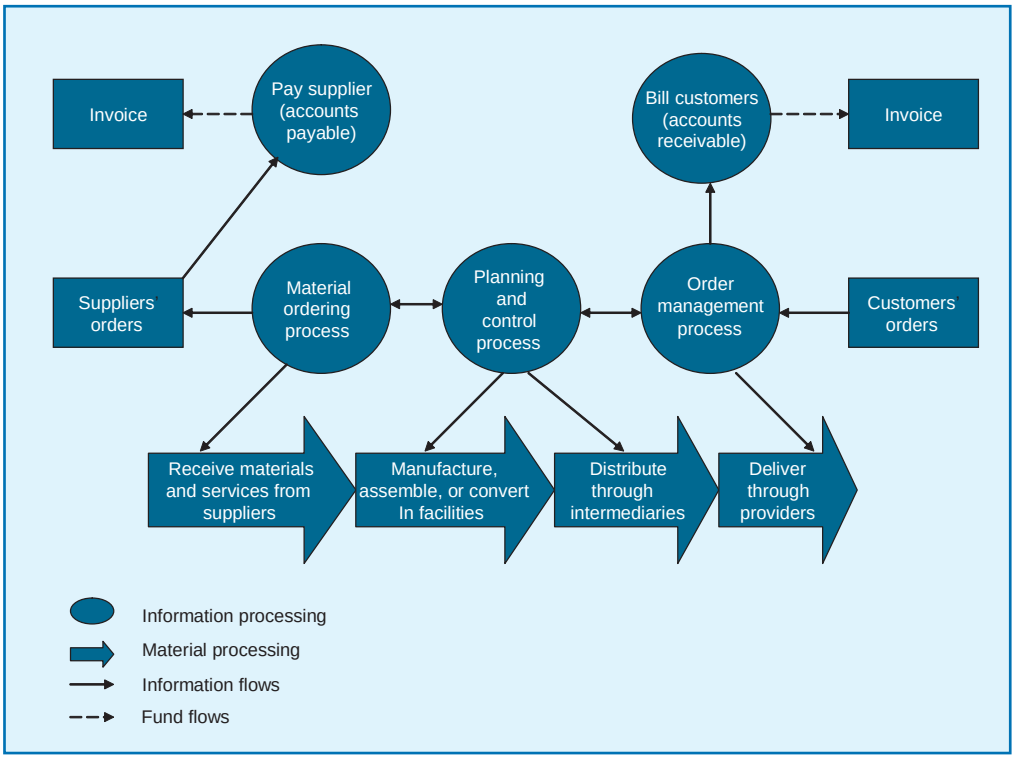
Supply chains and value chains are the real source of competitive advantage, and companies today no longer compete on products but rather through supply chains and value chains.

Value chains, as well as supply chains, can span the enterprises of a local economy, a supra-national regional economy, and the global economy. In this package, the importance of the value chain concept derives from the influence they have on the innovation

[21] Monczka, Trent and Handfield 2002; quoted by Kauffman, Ralph G., *op. cit.*
[22] *Source:* Kauffman, Ralph G., *op. cit.*
[23] *Source:* Raturi and Evans, 2005.

possibilities of developing countries' firms when they participate in the global operations of multinational enterprises. That is why the terms global value chains (GVCs) and global production networks (GPNs) are more currently used in this context.

Figure 1.6 Illustration of a supply chain network



Source: Raturi and Evans, 2005.

Global production networks. The global value chain (GVC) concept is increasingly complemented by that of global production networks (GPNs) of specialized independent enterprises, which captures complex systemic relationships and interrelations between firms. The production network concept reflects the process of accelerated fragmentation of knowledge-intensive activities in some value chains. Through modularization, technological knowledge acquires the characteristics of a standard commodity, allowing design and other knowledge-intensive technologies to be separated from the whole value chain system and to be performed in different geographical locations.

Leading multinational enterprises (MNEs) are playing a key role in organizing and controlling these global production systems, benefiting from locational differences in costs, infrastructure, capabilities in manufacturing, marketing and logistics, and in trade and investment regimes.

In a global production network (GPN), brand leaders such as IBM, Compaq or Dell, acting as flagship firms, allow suppliers to be independent but demand high performance from them. Brand leaders pursue cost reduction, product differentiation and time-to-market strategies through outsourcing volume and low-margin manufacturing and related support services.

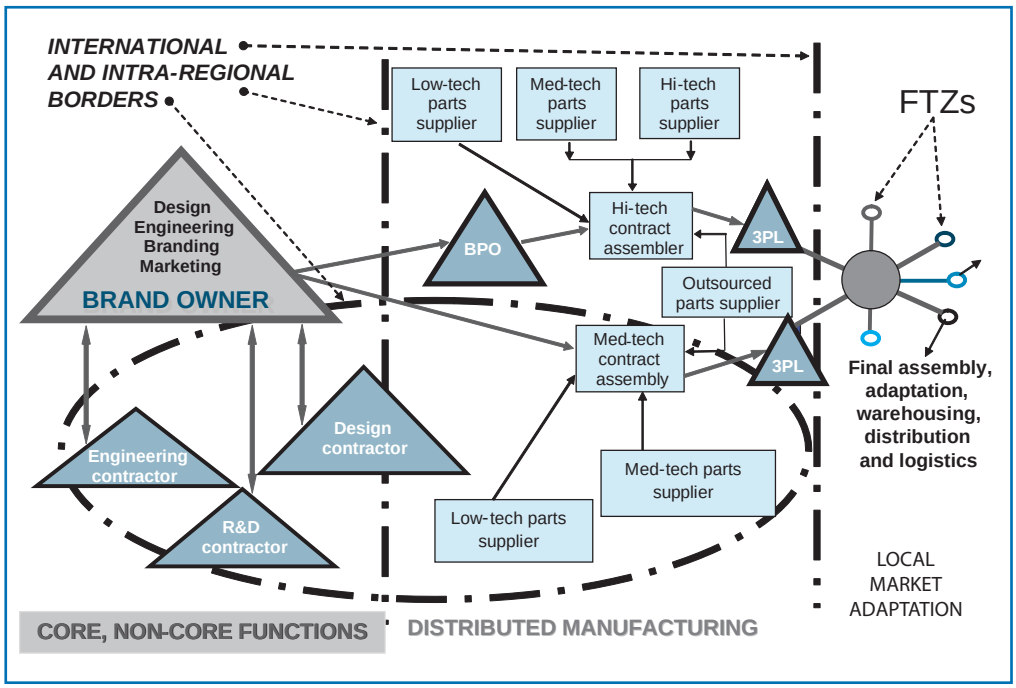
Triangle manufacturing appears in this connection as a strategy adopted by some contract manufacturers which take orders from the leading flagship firms and shift part or all of the requested production to other factories (wholly owned, joint ventures or independent) which form their own supply chains and production networks. The triangle is closed when the finished goods are shipped to buyers.

Triangle manufacturing appears in this connection as a strategy adopted by some contract manufacturers which take orders from the leading flagship firms and shift part or all of the requested production to other factories (wholly owned, joint ventures or independent) which form their own supply chains and production networks. The triangle is closed when the finished goods are shipped to buyers.

Source: UNIDO, 2004; *see also* Reading Materials, *Triangle Manufacturing*.

The growth, strategic direction and ownership position of participants in GPNs depend markedly on the flagship companies' strategy. Where final markets do not need customized inputs, they will prefer to purchase inputs on an arm's-length basis on the global markets, as with many primary commodities. But where a market demands more customized inputs, they often choose long-term relationships with reliable suppliers who meet their requirements. When necessary, they will help these suppliers to reach the desired standards. Sometimes MNEs prefer to internalize production in their value chains, for example when their discrete competencies are involved or where the transaction costs of helping suppliers are too large.

Figure 1.7 Integrated global factory



Source: P. Buckley, 2003; F. Bartels, 2005.

Integrated global factory is a term now gaining currency[24] to describe the complexity of the functional relationships and spatial distribution of the global operations of MNEs. Figure 1.6 illustrates the complexity of the picture, the configuration of which is dynamically changing according to the changing characteristics of industry competition and factor markets[25] as well as the policy environment of developing countries where MNEs implement their operations.

Adding to the complexity of the picture, the global strategies of MNEs assume parallel modes of market entry and servicing in multifaceted international patterns of inter- and intra-firm cooperative arrangements, described as "*alliance capitalism*",[26] which includes different types of cooperative arrangements, such as joint ventures, strategic alliances, co-production and marketing, co-R&D, contract design and manufacturing with equity and non-equity modalities.

1.2.4 Corporate social responsibility (CSR)[27]

In the past twenty years there has been a radical change in the relationship between business and society, with companies recognizing that improving their own impacts and addressing wider social and environmental problems will be crucial in securing their long-term success. Increasingly, high profile companies are implementing corporate social responsibility (CSR) processes, such as public commitment to standards, community investment, continuous improvement, stakeholder engagement and corporate reporting on social and environmental performance.

CSR is now being discussed and debated in the public policy sphere. The UK has a Minister for Corporate and Social Responsibility; the EU has published a Green Paper on the subject; 2005 has been designated the European year of CSR; and the United Nations Global Compact is bringing together companies and UN agencies to address CSR.

The basic drivers of CSR are:

(a) *Values:* a value shift has taken place within businesses where they not only feel responsibility for wealth creation but also for social and environmental goods.

(b) *Strategy:* being more socially and environmentally responsible is important for the strategic development of a company.

(c) *Public pressure:* pressure groups, consumers, the media, the state and other public bodies are pressing companies to become more socially responsible.

[24] Bartels, 2005; Buckley, 2003
[25] *See* Glossary.
[26] *See* Glossary.
[27] *See* Glossary.

Companies are often driven by one of the above but see a shift into other spheres over time. For example, for companies subject to high profile campaigns, such as Shell and Nike, the main driver of change has been public pressure. Over time CSR has gathered strength and strategic importance within companies as it is seen as a way of creating sustainable value. However, in the main, it has been public pressure centred on three key areas that has driven the CSR agenda. These comprise the environment, labor standards, and human rights, and it is no coincidence that these make up the nine principles of the United Nations Global Compact.

Although CSR has primarily been the concern of multinational enterprises (MNEs), it is increasingly involving small and medium-sized enterprises (SMEs), both as suppliers to international companies and markets and as recipients of support through donor-led programmes aimed at encouraging economic development. CSR affects SMEs in developing countries through direct supply chain relationships, and as a result of developments in legislation and international standardization and certification. It represents a change in the commercial environment in which SMEs operate and can be regarded in terms of its net effect on society. For some critics, CSR may result in a protectionist effect and impose inappropriate cultural standards or unreasonably bureaucratic monitoring demands on small business. In such case the net effect on the communities concerned would be a reduction in welfare. From another perspective, CSR offers opportunities for greater market access, cost saving, productivity and innovation to SMEs, as well as broader social benefits, such as improved education and overall community development.

United Nations Global Compact—the nine principles

The Global Compact is rooted in the Universal Declaration of Human Rights; the ILO's Fundamental Principles and Rights at Work; and the Earth Summit—Agenda 21 principles on the environment. The nine principles are:

Human rights

The Secretary-General of the United Nations asked world business to:

1. Respect the protection of international human rights within their sphere of influence.
2. Make sure their own corporations are not complicit in human rights abuses.

Labour

The Secretary-General asked world business to uphold:

3. Freedom of association and the effective recognition of the right to collective bargaining.
4. The elimination of all forms of forced and compulsory labour.
5. The effective abolition of child labour.
6. The elimination of discrimination in employment and occupation.

Environment

The Secretary-General asked world business to:

7. Support a precautionary approach to environmental challenges.
8. Undertake the development and diffusion of environmental responsibility.
9. Encourage the development and diffusion of environmentally friendly technologies.

Review of chapter 1.2

Global manufacturing strategies of MNEs

The opportunities for the internationalization of developing countries' firms is very much dependant on the dynamics of international business and, in particular, on the business strategies of multinational enterprises (MNEs).

In order to survive the competitive pressures and grow, firms resort to cost-reduction strategies, for example subcontracting, contract manufacturing, and outsourcing materials and other inputs. They also take advantage of locational benefits but, most of all, they have to invest substantially in R&D and innovation.

The operational strategies of multinational enterprises are influenced and shaped by several interrelated elements:

(a) intense competition for consumers' preference;
(b) liberalization of trade and FDI regimes;
(c) the mobility of capital; and
(d) advances in information and communication technologies.

With their openness to trade and investment and the coordination possibilities offered by the advances in information and communication technologies, MNEs can organize their operations in ways that better suit their interests, for example by using vertical integration, insourcing, offshoring or outsourcing.

Through outsourcing, a company or organization can concentrate on what it does best and can also take advantage of the provider's expertise. A decision to outsource has to balance economic considerations (e.g. costs and quality) and strategic considerations (e.g. danger of suppliers becoming competitors).

Outsourcing is not only sought by big companies; small businesses are also increasingly turning to outsourcing for a variety of reasons; in some cases, it is the question of cutting prices and surviving the pressure of competition.

Outsourcing innovation is becoming a trend that shows how far MNEs' strategies are evolving in their search for external sources of competitive advantage. Innovation is

outsourced not only through research contracts but also by acquiring complete designs from the dynamic innovative firms.

Supply chain and value chain are terms often used with the same meaning in the current literature, but there is a distinction in that value chain highlights the value added along the chain.

A typical supply chain involves three interrelated levels of intervention: material management functions; information processing functions; and functions of transfer of funds.

Supply chains and value chains are the real source of competitive advantage, and companies today no longer compete on products alone but rather through supply chains and value chains.

The global value chain (GVC) concept is increasingly complemented by that of global production networks (GPNs) of specialized independent enterprises, which captures complex relationships and interrelations between firms. The production network concept reflects the fragmentation of knowledge-intensive activities in some value chains and the possibility of their being performed in different locations.

In a global production network (GPN), brand leaders, acting as flagship firms, allow suppliers to be independent but demand high performance from them. Brand leaders pursue cost reduction, product differentiation and time-to-market strategies through outsourcing volume and low-margin manufacturing and related support services.

Alliance capitalism is a term used to designate the multi-faceted pattern of FDI operations which involve simultaneous collaboration with competitors and rivalry (in different economic spaces) with strategic and alliance partners, as well as participation in dense networks of technology suppliers.

The concept of the integrated global factory describes the complexity of the functional relationships and the spatial distribution of the global operations of MNEs, the configuration of which dynamically evolves according to the changing characteristics of industry competition, factor markets[28] and the policy environment of host countries.

Increasingly, high profile companies are implementing corporate social responsibility (CSR) processes, such as public commitment to standards, community investment, continuous improvement, stakeholder engagement and corporate reporting on social and environmental performance.

[28] *See* Glossary.

1.3 Opportunities for developing countries

1.3.1 Basic requisites for technological development

The global production systems can create opportunities for developing countries' producers to upgrade their technological and industrial capabilities and to integrate into the global economy.

The process mostly involves linkages between developing countries' firms and global players to acquire new technology and skills and to leverage those acquisitions in ways that get as much as possible from the new relationships.

Technological and industrial development is possible even for countries that have a low starting point. The achievements witnessed in Southeast Asia are encouraging and inspiring examples of that.

However, we have to keep in mind that each country has its own set of endowments and constraints and will have to find the path for development that suits its particular conditions; but whatever the options, there are common prerequisites and decisive factors for success which are inescapable and can be enumerated as follows:

(a) *Imported technological inputs.* The contribution of foreign inputs has been acknowledged as a critical factor for the technological progress of developing countries' firms and the economic growth of the recipient countries. Those inputs can be channelled through linkages of different kinds, for example technology acquisition through licensing or through foreign direct investment (FDI) with its spillover effects and backward linkages with local suppliers; joint ventures, with the consequent upgrading of local partners; original equipment manufacturing arrangements (OEM);[29] and participation in value chains.

(b) *Own technological effort.* In order to take full advantage of the linkages with foreign partners, developing countries' firms have to undertake a conscious, purposeful and consistent technological effort to learn from them and move up the technology ladder from basic assembly operations to having their own design and own brands and towards internationalization and market leadership. The

Factors for technological growth of developing countries' enterprises

- *Imported technological inputs:* linkages with foreign partners, participation in global production chains and networks
- *Own technological effort:* willingness to grow and internationalize; investment in R&D, innovation and learning
- *Government support:* enabling policies; availability of technological infrastructure and supporting institutions

[29] *See* Glossary.

technological effort can occur everywhere in the enterprise, not only in R&D activities but also in shop floor operations and in managerial strategies; but it can also draw substantially from outside sources, such as suppliers, customers, from the institutions that form the national innovation system,[30] and from specific government support services.

(c) *Government policies and support.* The role of government is critical for the development process, both at the macro level and at the enterprise level. Foreign investors and partners would only be willing to operate in the country or establish cooperative arrangements with local enterprises if governments are able to create the legal, institutional and infrastructural conditions that inspire confidence and make foreign operations in the country competitive and profitable.

Nor might the domestic firms be able to succeed in their own technological efforts without government policies and institutions aimed at supporting their learning and internationalization efforts. Indeed, only governments can coordinate the many elements to form a coherent strategy for industrial and technological development. Where this has been done effectively, as in some East Asian economies, the results have been spectacular.

1.3.2 Technology development through value chains: linking, leveraging and learning

Technology development at the firm level in developing countries is the result of a process of innovation and learning[31], which usually starts by importing technology for production purposes and grows over time into the capabilities of improving the technology and creating new technology.

There are different ways of accessing technology and capturing technological knowledge, for example through licensing, original equipment manufacturing (OEM), joint ventures and alliances, and participation in value chains and global production networks.

In all cases, the concept of "linking, leveraging and learning"[32] captures what firms—and countries as well—have to do to foster their technological development.[33]

Linking: connecting with outsiders to acquire needed technologies and skills;

Leveraging: going beyond arms-length transactions to squeeze as much as possible from the new relationships with those outsiders;

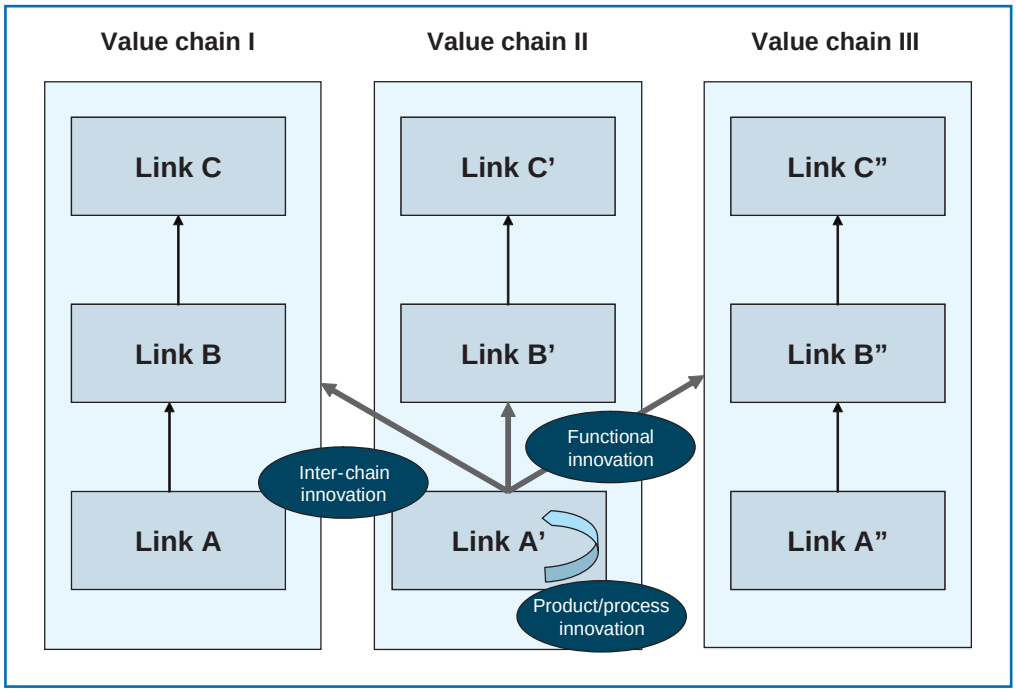
Learning: making the many efforts to master the processes of technologies, consciously building the foundation for improving current technologies—and creating new ones.

[30] *See* Glossary.
[31] *See* Glossary.
[32] *See* Glossary.
[33] *See* UNIDO, 2002.

Linking to global value chains and global production networks brings firms of developing countries the opportunities to upgrade their technological and industrial capabilities and to integrate into the global economy. It can provide better access to markets and to the knowledge of leading players and represents a platform to learn and create new capabilities.

Local enterprises need to possess high technological capabilities to be included by a flagship firm in its global production network. Once selected, participants can benefit from the network capability formation and development, which is the core of the strategy adopted by a flagship firm to raise the competitiveness of its network. Furthermore, the insertion of developing countries' enterprises in a global value chain puts great pressure on those enterprises to meet demanding quality, reliability and logistic standards, and induces the firm to improve its efficiency in individual activities and move to higher levels of technological capabilities, competitiveness and growth. Over time and as a result of the leveraging and learning that comes from participation in global value chains and global production networks, developing countries' firms will be able to upgrade their operations in different ways and directions, as illustrated in figure 1.8: *(a)* by changing the mix of activities and moving to upper links of its value chain; or *(b)* by innovating in such a way that moving into other value chain becomes possible. In this connection, four kinds of innovation can be distinguished: process innovation (improving the efficiency of internal processes), product innovation (improving products through quality, price performance and differentiation), functional innovation (raising value-added by changing the mix of activities conducted in the firm), and inter-chain innovation (moving into a new more profitable value chain).[34]

Figure 1.8 Innovation trajectories in value chains



Source: UNIDO, 2004.

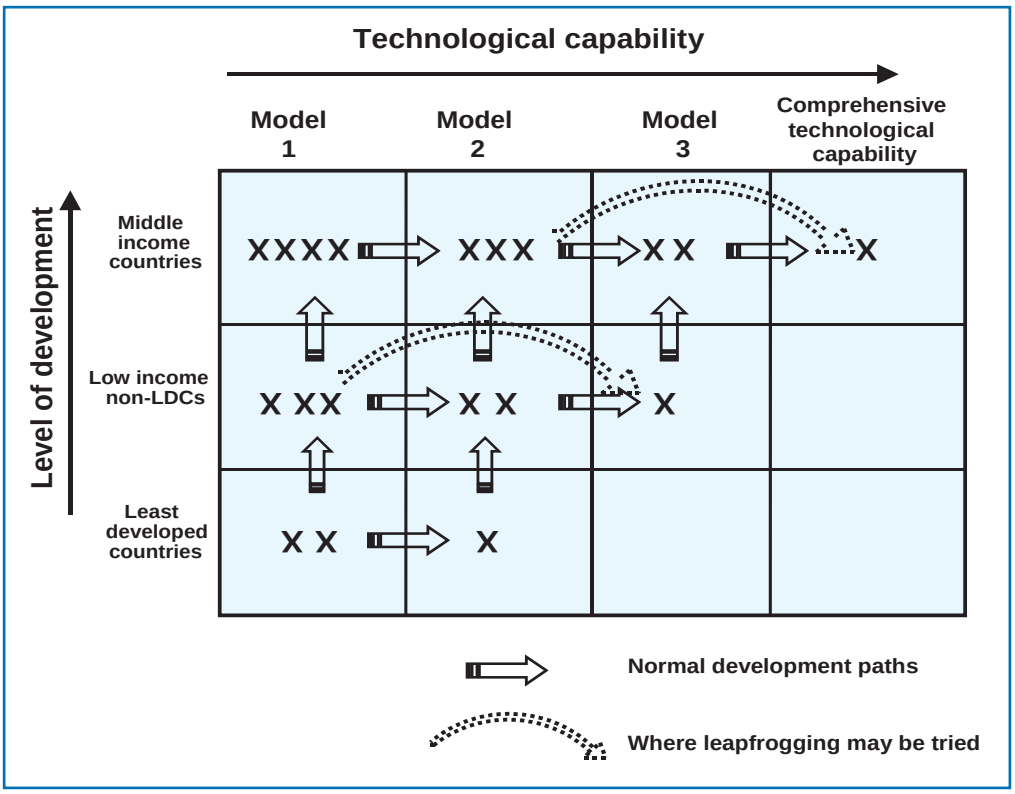
[34] *See* Glossary.

1.3.3 Development pathways; role of governments

Development pathways

In order to be selected to participate in global value chains and global production networks, developing countries' firms need to possess significant technological capabilities, which means they must have already gone through a certain process of capability building. Different countries and their firms start from different levels of industrial development and technological capabilities; at every starting level, there is scope for capacity-building, upgrading and further development along pathways determined by the overall country conditions and level of development, by government policy options, and by the technological capability of firms.

Figure 1.9 Illustration of technology development pathways



Source: UNIDO, *Innovative Technology Transfer Framework*, 2002.

Figure 1.9 provides an illustration of the usual technology development pathways. For least developed countries (LDCs) with a low level of development and technological capability, a possible option could be based on trade and aid, import-substitution strategies and an effort at the firm level to improve the efficiency of operations, upgrade technology and achieve acceptable quality standards for products (Model 1). Low income non-LDCs with an intermediate level of technological capability and infrastructure may be able to attract FDI, to set up export oriented activities in the country, or to establish subcontracting and OEM (original equipment manufacturing)[35] arrangements with

[35] *See* Glossary.

local companies (Model 2). At a more advanced level of development and capability, developing countries and their enterprises have the conditions for active participation in global value chains and global production networks and, through that, to achieve a comprehensive technological capability (Model 3).

Role of governments: a historical overview

The illustration above of possible development pathways also reflects the experience and the success stories of some developing countries, in particular the transformation that East Asian countries have gone through in the last few decades. In all cases, government policies and support (differently designed and implemented from country to country) played a critical role in the upgrading and internationalization of domestic enterprises, as for example:

Taiwan Province of China

(a) *Capacity-building* through the development of national technology systems: the government used the policy process to link and adjust its technological infrastructure to technological changes occurring in the global economy and to the needs of the large number of indigenous and export-oriented SMEs in Taiwan Province of China.

(b) *Policy focus:* strong links were built up between the national technology and innovation system, the country's SMEs and the international economy.

(c) *Public institutions:* contributions were made by:

- investment promotion agency (identified suitable industries and technologies);
- science and technology institute (facilitated the acquisition, reverse engineering and diffusion of technology);
- export-marketing agency (provided firms with relevant information on markets);
- cluster-supporting agency (linked larger firms to clusters of smaller firms).

South Korea

(a) *Capacity-building* through linked learning between large firms and large MNEs: the government used the policy process and technological infrastructure to promote high-speed technological learning and large-scale indigenous conglomerates.

Examples of pathways to capability building in East Asian countries

- Through development of national technology systems *(Taiwan Province of China)*;
- Through linked learning between large domestic firms and large MNEs *(South Korea)*;
- Through linked learning of SMEs participating in GVCs *(Singapore and Malaysia)*.

(b) *Policy focus:* the policy process focused on building a relatively small number of large indigenous national firms that could compete with developed country multinational corporations. The firms also relied on the government's restrictions on foreign capital to ensure that foreign direct investment, licensing agreements and technical assistance agreements hastened the building of firm-level technological capabilities.

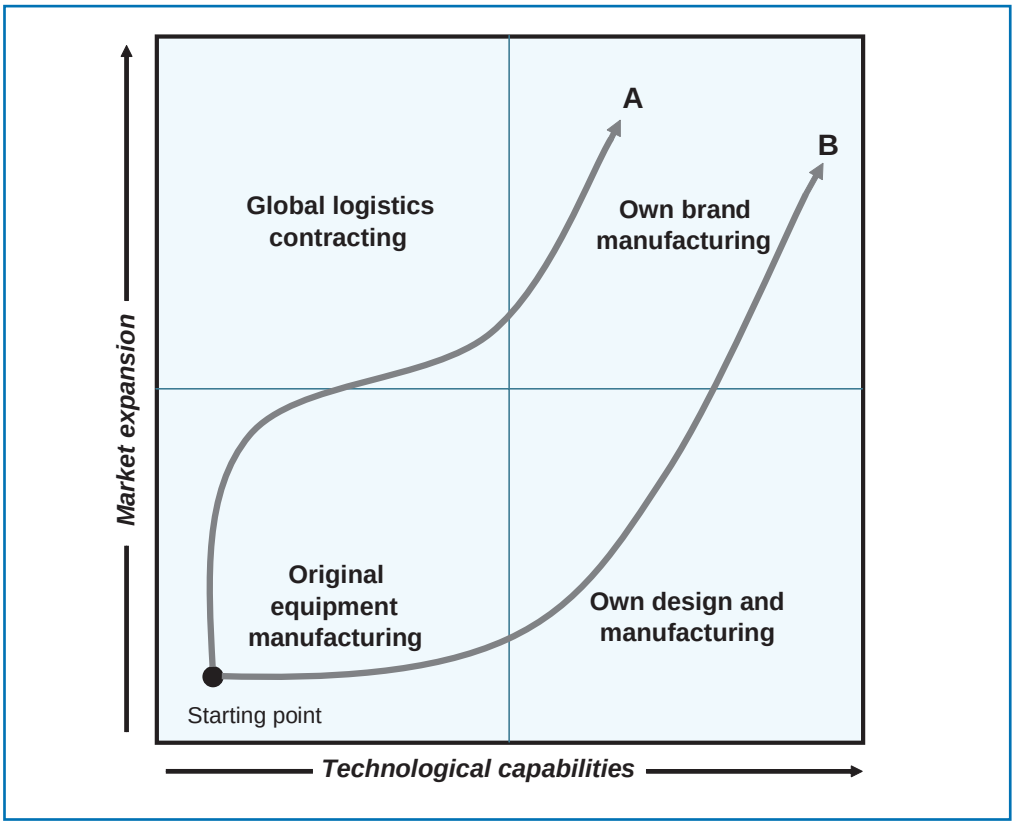
(c) *Public institutions:* Through a very solid institutional framework, including the state-owned banks, the government allocated performance-based promotional privileges, for example subsidized credit, to a small number of what became very large conglomerates.

Singapore and Malaysia

(a) *Capacity-building* through linked learning of SMEs participating in global value chains: governments used the policy processes and the technological infrastructure to promote linkages between indigenous SMEs and the global value chains of MNEs.

(b) *Policy focus:* initially, the policy process focused on the development of infrastructure facilities and the human capital base, an incentive system, and the institutional framework needed to attract multinationals from developed countries. Subsequently, in order to create an indigenously-owned industrial base, the governments in Singapore and Malaysia restructured the policy process to promote the participation of indigenous SMEs in the global value chains of multinationals located in each of the countries.

Figure 1.10 Asian experience at firm level



Source: Adapted from UNIDO, 2003.

(c) *Public institutions:* contributions were made by:

- investment promotion agencies (they scoured the globe for firms and industries to attract);
- agencies responsible for industrial estates (IEs);
- export processing zones (EPZs):
- licensed manufacturing warehouses (LMWs).

Figure 1.10 illustrates how Asian firms managed to learn and innovate within global value chains, and moved from OEM (original equipment manufacturing) to technological leadership and own brand manufacturing (OBM). Two kinds of leveraging strategies were used, market expansion and technological capability building. Own brand manufacturing, usually the most profitable segment of a global value chain, requires both marketing and technological competencies. Path A in figure 1.10 represents a trajectory along which many of the activities entailed in original equipment manufacturing, all of them initially accomplished domestically along with key activities, are relocated to production facilities in third countries, giving rise to "triangle manufacturing". Capability enhancement is centred on mastering the complexity of the logistical functions required when sourcing and combining inputs from a number of different producers and locations. Path B, in contrast, focuses on capability enhancement through expanding functional responsibilities, from original equipment manufacturing to including some responsibility for design, leading the enterprise to then market its own designs under its own brand (own brand manufacturing—OBM).

Review of concepts and issues: "alliance capitalism" and "integrated global factory"

The concepts of integrated global factory and alliance capitalism, which were introduced in section 1.2.3 above, portray the intricate mechanisms used by multinational enterprises in their global operations. On the one hand, such models and strategies represent the reaction to competitive pressures, increasing uncertainty, volatility, and perception of risk (as mentioned above, many big enterprises have been unable to survive the "turbulence" of the new economy). On the other hand, the flexibility MNEs can afford in their modes of entry and operations management is the result of external factors such as:

(a) advances in the field of information and communication technologies which made possible the coordination and handling of the global value chains and global production networks; and

(b) the new policy approaches of developing countries, which understand the growing importance of FDI and linkages with foreign enterprises as major drivers for their development and growth and consequently compete among themselves for eligibility in the location decisions of MNEs, for example, through liberalization of their foreign investment regimes, low wages, lax environment standards or tax incentives.

1.3.4 Issues for developing countries

The preceding sections provide a picture of the present development scenario, showing how it shapes the behaviour and the strategies of MNEs, bringing to light the opportunities and benefits that developing countries and their firms can have as a result of MNEs' operations, and underscoring the critical role of governments in the process. In the present section, we will review the complexity of FDI today and the corresponding issues developing countries are confronted with.

For multinational enterprises, in their quest for lower costs, better quality and faster distribution of goods to the markets, the location factor in FDI-related decisions will be influenced by the answers to questions like these:

- Are there domestic firms that are able to participate in the investor's network and bring value-added to its operations?
- Where can the various production segments of the value chain be located in order to maximize the difference between manufacturing value-added and the locational cost structures?
- What kind of control modalities should be established with each node of the production network, i.e. should the preference be for full ownership or for another form of collaboration such as outsourcing, strategic alliance or joint venture?

MNEs' location decisions: questions

- Availability of favourable factor markets and capable domestic firms in host country;
- Comparative assessment of cost structures in possible alternative locations;
- Choice of control modalities for each location, e.g. full ownership, outsourcing, etc.

For governments of developing countries, there are both challenges and opportunities in the present structure and features of global manufacturing operations and in the fact that MNEs change their locational decisions according to the changing characteristics of industry competition and factor markets.

The Asian experience briefly presented above is a valuable guiding light for policy makers of other developing countries who may wish to emulate it and achieve the same kind of performance; but the strategies that were effective during the 1970s and 1980s would not work in the same way in the 1990s and later. While MNEs once used East Asian firms for manufacturing and assembly operations under subcontracting or OEM arrangements (which eventually led to their present technological level of self-sufficiency and innovative capability), nowadays they rely increasingly on turnkey suppliers for technology-intensive segments of their value chains. In this situation, latecomer firms from developing economies may be at a disadvantage vis-à-vis East Asian firms, and developing countries may be further marginalized in the global economy

unless they can upgrade their industrial sectors and innovation systems so that domestic producers can reach systemic efficiency.

Understanding the features of the international operations of MNEs is essential for developing countries if they are not to be sidelined in the race for development. MNEs' operations management is characterized by flexibility in the choice and change of partners for their networks and value chains as well as in their market entry and exit decisions.

Again, it is opportune to bring attention to the role of the information and communication technologies which gave MNEs not only the capability to manage dynamic relationships and spatially dispersed operations but also the tools to collect vast amounts of data, leading to their acquisition of information and knowledge about technology and markets and their trends and thus improving their forecasts and reducing the costs of changing the location of their international manufacturing operations.

Value chain and production network analysis is also an important tool for strategic policy-making. It helps to better understand the structure of specific value chains, and identify the characteristics of their leading firms and the ways they might wish to incorporate developing countries' producers in these value chains; the type of work allocated to developing countries and firms in the chain and whether such works can sustain their jobs and income; and the strategies and policies that can help developing countries to successfully leverage their participation in GVCs and GPN's to achieve productivity enhancement and welfare gains.

For developing countries, such tools have the same relevance, *mutatis mutandis*. The prospects are lousy for countries that are on the wrong side of the digital divide, i.e. that lack capacity and have low skills in using information and communications technologies. The availability of an information and communications infrastructure is indispensable in bringing in foreign investors or allowing for the participation of domestic enterprises in global value chains or global production networks. Furthermore, policy-makers of developing countries also need massive and continually updated information and business intelligence to learn about the relative differences in factor conditions[36] and costs among countries and within regions, to anticipate the moves and directions of change of MNEs' production and subcontracting networks, and to decide which policy measures, adaptive structures and incentives would achieve the integration of domestic firms in such networks.

In general terms, policies are recommended for developing countries on two levels:[37]

At the industry level

Efforts should be focused on medium- and high-tech manufacturing activities. This calls for productivity enhancement through skills and technology upgrading and through setting up backward linkages to the local industries and forward linkages to markets.

[36] *See* Glossary.
[37] UNIDO, 2002.

At the national-economic level

It is crucial to develop structural factors that allow industrial up-grading. This includes public investment in enhancing the physical and knowledge infrastructure and utilities, in the provision of technology extension services, in setting up export processing zones and industrial and technology parks, and in providing financial incentives (tax relief, loans, and so on). Equally important are reforms of labour law and of institutions and government structures.

In order to give shape and focus to the general policy prescriptions and adjust them to the specific country conditions, it is also recommended that "needs assessment and diagnostic" exercises be implemented in order to identify the strengths and weaknesses at the different levels of intervention (e.g. policy, institutions, infrastructure, industries, resources), to calibrate the policy instruments, and to decide on the most suitable development pathways.

Review of chapter 1.3

Opportunities for developing countries

The global production system can create opportunities for developing countries to upgrade their technological capabilities and integrate into the global economy. As a rule, the successful cases of technological progress in developing countries are related to FDI operations and to linkages between local companies and multinational enterprises.

In order to take full advantage of the linkages with foreign partners and grow technologically, developing countries' firms have to maintain a consistent effort of innovation and learning. The role of governments is also important, both to create conditions to attract foreign investors and to assist domestic companies in their learning and internationalization efforts.

To be eligible for participation in global value chains (GVCs), developing countries' enterprises need to have substantial capabilities in place. Over time, and through innovation and learning, firms can move into higher links of the value chain or into new and more profitable value chains.

Different countries have followed different development pathways, depending on the overall conditions, government options and the capabilities of their firms.

For least developed countries (LDCs) with a low level of development and technological capability, a possible option could be based on trade and aid, import-substitution strategies and an effort at the firm level to improve the efficiency of operations, upgrade technology and achieve acceptable quality standards for their products.

In the case of Taiwan Province of China, the development policy focused on the support to SMEs in their upgrading and internationalization through:

(a) the creation of strong national technology systems; and
(b) the adjustment of its technological infrastructure to the requirements of the global economy and the needs of export-oriented SMEs.

In the case of South Korea, the approach to capacity building was based on linked learning between large firms and large MNEs. The government used the policy process and technological infrastructure to promote high-speed technological learning and large-scale indigenous conglomerates.

At the start, the development efforts of Singapore and Malaysia gave priority to the attraction of FDI; subsequently, they reoriented their policies, including their technological infrastructure policy, in order to promote the participation of indigenous SMEs in the global value chains of MNEs.

The development strategies that have been effective in Asian countries during the 1970s and 1980s may not work for other developing countries in the 1990s and onwards. Understanding the features of the international operations of MNEs is essential for developing countries to capture FDI or integrate their firms in global value chains and global production networks.

2 Strategic alliances and joint ventures

2.1 Business alliances: a broad concept and a blurred terminology

There are many forms of inter-enterprise collaboration arrangements, and the terminology describing them is far from uniform and consistent in the specialized literature and among leading authors. This is confusing for readers who wish to understand the scope, characterization and differentiation of the various ways in which business firms collaborate. In many works, terms like "joint ventures", "collaborative agreements", "partnerships", "business alliances", "strategic alliances", or simply "alliances", are used in a generic and interchangeable way. Some authoritative sources give certain of those terms a specific scope and a well-defined meaning, but we also see that other equally authoritative sources use the same terms with different and sometimes rather blurred meanings. The examples below will illustrate this.

(a) Doz and Hamel, in *Alliance Advantage*,[38] use the terms alliance and joint venture as substantively differentiated concepts. They elaborate at length on the distinction between these two forms of inter-enterprise collaboration. Furthermore, for those authors the term alliance has a clear connotation with the notion of strategic alliances, which will be presented later.

(b) Bamford, Gomes-Casseres and Robinson, in *Mastering Alliance Strategy*,[39] give the concept of alliance a rather broad and encompassing scope, covering a wide range of forms in both classic equity joint ventures and non-equity relationships, and including enhanced supplier agreements, contractual research collaborations, marketing affiliations, licensing agreements and multi-partner consortia.

In part 1, we have already introduced and characterized various types of collaborative agreements that fit well to the broad definition of alliances (or business alliances) referred to above—for example, the cases of licensing agreements, franchising, equity alliances, joint ventures, consortia, and contract manufacturing, which were introduced in part 1, section 1.5, when dealing with market entry strategies. Also, some of the relationships that MNEs establish with suppliers and partners in the form of global value chains and global production networks, or those presented in the concept of integrated global factory (part 1, section 2.3), can be regarded as alliances.

> In a broad definition, we can designate as business alliances or simply alliances practically all forms of collaborative relationships between separate companies that involve joint contributions and shared ownership and control.

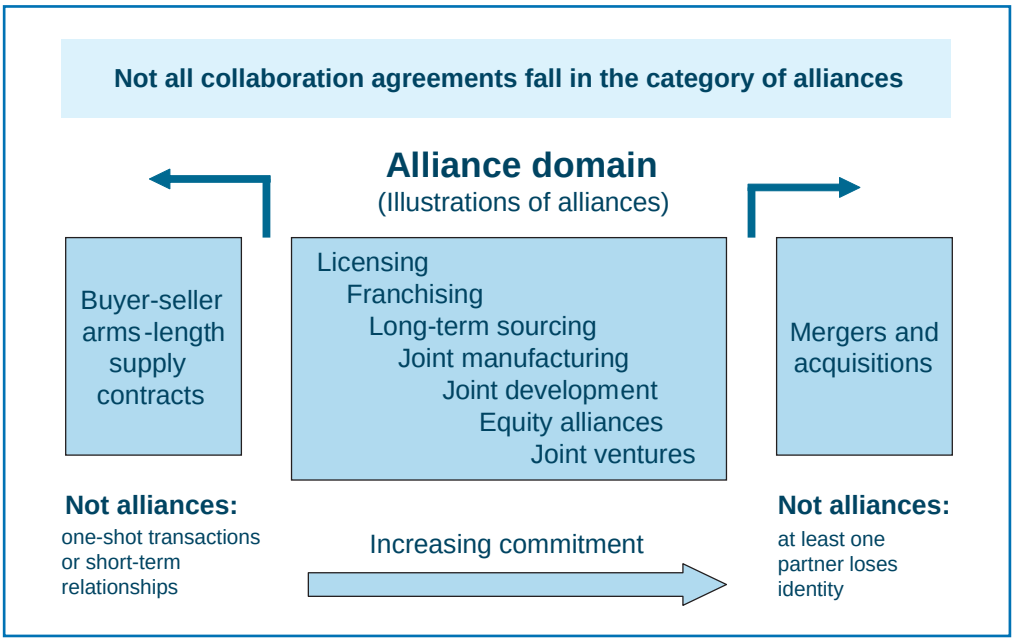
Although we can adopt a rather broad definition of the term alliance, we should not go too far, to the point of indiscriminately including all forms of collaborative agreements and other inter-enterprise agreements in the concept. Mergers and acquisitions, for example, should not be regarded as alliances since they represent cases where at least one of the parties loses its corporate identity. Neither should we use the term alliances for many subcontracting and outsourcing arrangements which are established as

[38] Doz, Y. L., and Hamel, G. *Alliance Advantage*, Harvard Business School Publishing Corporation, 1998.

[39] Bamford, J. D., Gomes-Casseres and B., Robinson, M. S., *Mastering Alliance Strategy*, Jossey-Bass, 2003.

arm's-length contracts as a result of competition among different suppliers. These are business relationships that only last as long as the supplier remains competitive in the contractor's eyes. The notion and spirit of collaboration—or alliance—is missing in this kind of situation. But there are cases of subcontracting and outsourcing arrangements which could appropriately be included in the category of business alliances, as, for example, the relationships that some car manufacturers establish with their suppliers of parts by providing them with know-how to improve their processes, product quality and adaptability to changing requirements. Suppliers, in turn, realize that the relationship has a stable and durable foundation and will be more motivated to provide higher levels of cooperation, which can include design expertise and value-chain management.[40]

Figure 2.1 Not all collaboration agreements are alliances



In order to shed more light on the broad landscape of business alliances and give sharpness and clarity to the concepts and terms, we will, as far as possible, use examples that reflect real life situations that are familiar to practitioners and the public at large. As a start, here are two substantially different illustrative cases:

Alliance between Coca-Cola and McDonald's: an informal but strong and long-lasting alliance

Coca-Cola and McDonald's have had an alliance since the 1950s, when Ray Kroc, the founder of McDonald's Corporation, convinced a Coke executive called Waddy Pratt to provide him with Cola. The alliance did not need any written document to come into being and yet it has grown stronger over the years on the basis of trust, shared interests and a positive impact on revenue and growth without the commitment of capital. Other important factors for the success and

[40] Daniels, J. D., Radebaugh, L. H., and Sullivan, D. P., *International Business—Environments and Operations*, Pearson Education, Inc., 2004 (pages. 551–552).

stability of this alliance is that these two companies are not competitors but rather complement each other, both are leading global brands, and they stand side by side as powerful symbols of the American way of life. Their alliance goes far beyond a customer-supplier relationship. Coca-Cola, with sales in many countries where McDonalds has no representation, has helped its partner to set up new operations in those countries by making available its knowledge of the local market and conditions and providing relevant logistical assistance, from banking relationships to equipment design.

The alliance has been nurtured over the years by considerable personal contacts at the board level, by joint participation in promotional events, and at company gatherings which are choreographed to remind employees of the strong and important alliance ties between the two companies.

Alliance of Coca-Cola with McDonald's: reasons for long-time success

- The partners are not competitors in core businesses
- The partners are both strong and leading global brands
- The partners have a practice of strengthening trust
- The partners help promote each other's business

Alliance between Nokia and Sanyo: an example of a joint venture

On the occasion of the 3GSM World Congress held in Barcelona on 13–16 February 2006, Nokia announced its plans to stop making phones for CDMA and unveiled the setting up of a joint venture with Sanyo to pursue the CDMA business. The background to this is:

(i) The two most common and competing standards used in mobile telephones are GSM (Global System for Mobile Communications) and CDMA (Code-Division Multiple Access).

(ii) Nokia is the market leader for GSM handsets with close to a 40 per cent market share but has been unable to make profits or go beyond a 13 per cent market share in CDMA.

(iii) The CDMA standard is dominant in North America and parts of Asia, including South Korea, and is also present in other big markets, such as Japan, India and Brazil.

(iv) Nokia has to face stronger competitors in the field of CDMA technology but, despite high R&D and marketing expenses, has been unable to keep pace with its rivals, namely with Qualcom, which owns basic patents in this field.

(v) Sanyo is a diversified Japanese electronics firm which also makes CDMA phones but, with a modest market share of 7 per cent, is well behind rivals such as Samsung, LG and Motorola. Furthermore, it has been in a weak financial position with limited cash and resources to put into the vital task of developing new handsets.

Drivers of alliance Nokia vs. Sanyo

- Cell phone industry is a highly competitive field requiring heavy investments in R&D and innovation
- Both partners are in a weak position in CDMA technology and unable to gain market share
- Both partners have complementarities in technology, market segments and geographical outreach

The joint venture announced in Barcelona is expected to result in a win-win situation, in view of the following circumstances and expectations:

(i) The two companies combined may reach a 20 per cent CDMA market share, which means a stronger Nr. 2 position behind Samsung.

(ii) The partners bring to the joint venture complementary strengths in terms of product lines and markets. In the CDMA business, Nokia has been targeting more the mid and low-end levels, while Sanyo has a leading position in mid-range and high-end CDMA handsets. The new venture will, therefore, be able to provide a comprehensive range of product offering. In terms of market perspectives, Sanyo has successful relationships with CDMA operators in the U.S. and Japan, where Nokia has long struggled to gain market share, while Nokia is stronger in big markets like India and Brazil, and its brand has the clout to boost the CDMA line in developing countries.

(iii) By joining hands, both Nokia and Sanyo stand to gain. The deal will allow the firms to share the high development costs for CDMA while providing "both parties timely access to R&D competencies that complement their own internal strategies."[41]

The new venture will be based mostly in Osaka and San Diego, will have around 3,500 employees and is expected to start operations in the third quarter of 2006. Contractual details will, in the meantime, be negotiated and settled, including those related to the contributions of each of the partners, the allocation of management responsibilities, the branding of the products and the conditions of access by the partners to the joint venture's R&D competencies.

To sum up: As the above examples show, the concept of alliance is related to a spectrum of substantially different business fields, realities and motivations. The alliance of Coca-Cola with McDonald's is a non-equity alliance, which can be characterized as follows:

(a) Both companies are strong leaders in their fields of business and not competitors with each other.

[41]Press release of February 14, 2006, "*Nokia and Sanyo Announce Intent to Form a Global CDMA Mobile Phones Business*".

(b) Both partners benefit from the alliance in terms of growth and revenue with no need to commit resources.

(c) The alliance was not formalized in writing and yet it has been in force and remained strong for decades.

The alliance envisaged by Nokia and Sanyo has a totally different nature and is driven by very different motivations:

(a) The firms are competitors but each is in a weak position in the CDMA cell phones market.

(b) The competition is very aggressive in terms of technology development and the introduction of new models; each of the firms alone has been unable to increase its market share.

(c) By forming an alliance, Nokia and Sanyo will share the high development costs of new CDMA phones, gain synergies in the range of models and access to expanded markets and achieve a meaningful market share.

(d) The alliance will take the form of a joint venture, which means a new jointly-owned company, based on assets, resources and financial and managerial arrangements that the partners will negotiate and set out in detail.

Review of chapter 2.1

Business alliances: a broad concept and a blurred terminology

In current business practice, terms like joint ventures, partnerships, alliances, business alliances and strategic alliances are often used in a generic and interchangeable way.

The concept of alliance, in a broad sense, covers a wide range of collaborative arrangements, such as equity joint ventures, licensing agreements, joint R&D and multi-partner consortia.

Some forms of collaboration agreements should not be regarded as alliances, for example traditional subcontracting and outsourcing and arms-length supply contracts. However, subcontracting and outsourcing arrangements may be regarded as alliances when the relationship becomes stable and durable through enhanced forms of collaboration.

The formation of alliances can be driven by substantially different realities and motivations, as illustrated by the alliances between Coca-Cola and McDonald's, on the one hand, and Nokia and Sanyo, on the other.

Coca-Cola and McDonald's entered an alliance because they were both strong in their fields, did not need to invest, and the alliance could only bring gains; Nokia and Sanyo are seeking an alliance because they are each in a weak position in the CDMA market and need to find complementary resources to achieve sustainable competitiveness.

The alliance between Coca-Cola and McDonald's did not need any written document to come into being, and yet it is an example of a long-lasting alliance that has grown stronger on the basis of trust, shared interests and the fact that it has had a positive impact on revenue and growth with no need to commit capital.

The alliance between Nokia and Sanyo involves the formation of a joint venture and requires substantial investments, the allocation of R&D competencies and the sharing of development costs. In such a case, the partners need to negotiate and settle all the details of the deal, including the contributions of each of the partners and the allocation of managerial responsibilities, branding of products, etc.

2.2 Overview of alliance forms

Business alliances can take many forms, a number of which were characterized in section 1.5 of part 1. In the sections below, we provide a review of the most common alliance forms with related examples. The list is not exhaustive. Other terms can be found in the literature, the totality reflecting the wide range of motives that lead to inter-enterprise collaboration. In any case, the coverage can be regarded as comprehensive enough to establish and make clear the broad picture of business alliances.

2.2.1 Licensing

Under a licensing agreement, a company designated as a licensor, allows another entity, designated as a licensee, to use its know-how and other intellectual property assets, like patents and trademarks, for the manufacture and sale of the company's products. In exchange for the rights granted by the company, the licensee has to pay a compensation designated as a royalty, usually established as a percentage of the sales of the licensed products. The licensing agreement sets out the rights and obligations of both parties, for example the scope of the licence, the technical assistance to be provided by the licensor to the licensee if needed, the level of royalties the licensee is obliged to pay to the licensor, the duration of the contract, the countries where the licensee is allowed to sell the licensed products, the consequences of termination, etc.

In addition to the introduction to licensing already given in part 1, section 1.5, this form of collaboration will be dealt with in more detail in the chapters related to international negotiations and in those dealing with joint ventures. The example below shows a strategic licensing arrangement between a licensor (Xerox) and a licensee (Fuji-Xerox) which itself happens to be a joint venture where the licensor has equity participation.

Licensing agreements between partners in joint ventures are quite common but they also represent a form of business alliance between independent firms, for example when the licensor wants to get an income from its proprietary technology without the burden and risk of investment.

Example: Xerox and Fuji-Xerox

As early as 1962 and as a way of entering the Japanese market, Xerox established a 50/50 joint venture with Fuji Photo.[42] The new company thus formed was given the name Fuji-Xerox. Xerox then licensed Fuji-Xerox its xerographic patented know-how for the manufacturing of photocopiers against a royalty fee of 5 per cent of the net sales. The licensing agreement was originally granted for 10 years and has subsequently been renegotiated and extended several times. The agreement was limited to direct sales by Fuji-Xerox in the Asia Pacific Region but also provided for the supply of photocopiers to Xerox to be sold in North America under Xerox's label. In the year 2001, Xerox sold 50 per cent of its holdings to Fuji Photo and the ownership of Fuji-Xerox became 25 per cent for Xerox and 75 per cent for Fuji Photo. But the joint venture went on with the new equity structure and, in 2004, the company was employing 36,000 people.[43]

[42] *Source:* Wikipedia
[43] *Source:* Press release by Samsung and Sony, 14 December 2004.

2.2.2 Cross-licensing

Cross-licensing is the mutual sharing of patents between companies with or without the exchange of a licensing fee, depending on whether the patent portfolios that are exchanged are of an unequal value or have a comparable worth.

Cross licensing is often undertaken between firms working on R&D related to similar products, in which case the similarity of their objectives and work may lead to duplication of each other's innovations. By cross-licensing arrangements the firms involved can, on the one hand, achieve substantial synergies and, on the other, avoid the risk of patent infringement, which can be costly and difficult to resolve.

Example: Agreement between Samsung and Sony

In December 2004, Samsung and Sony signed a cross-licensing agreement aimed at sharing patents across major product lines. The agreement, which took one year to negotiate, covers about 11,000 patents by Samsung and about 13,000 patents by Sony filed in the U.S. The goal is to construct a mutually beneficial relationship whereby Samsung and Sony can use each other's patent portfolios and effectively keep pace with the fast and sophisticated advancement of digital technologies.

The agreement, however, does not apply to "differentiation technology patents", such as Sony's Digital Reality Creation (DRC) and PlayStation Architecture, and Samsung's TFT-LDC and Organic Light Emitting Diode (OLED).

Both Sony and Samsung recognize that the cross-licensing agreement will reinforce their ability to provide better products and services to customers worldwide while, at the same time, maintaining each company's uniqueness and competitiveness.[44]

2.2.3 Franchising

In some respects, franchising may be regarded as a particular form of licensing, but, in current business practice, licensing and franchising are substantially different and distinct concepts.

In a typical licensing agreement, the licensee manufactures a certain product based on the licensed technology, pays a royalty to the licensor for the rights granted under the licensing agreement and sells the licensed products according to its own managerial and marketing strategies.

In franchising, which is employed primarily by service firms, it is the whole business concept that is the subject of a franchising agreement whereby the owner of the concept, or franchisor, allows another company, or franchisee, to replicate that very kind of business and offer the same kind of products with a high degree of standardization with the same concept, model, image and quality standard.

The franchisor, in turn, will provide the franchisee with the licenses required to use the know-how, trademarks and other proprietary elements; it will also make available to the franchisee all the technical assistance, training of personnel, product specifications, etc.

[44] *Source:* Press release by Samsung and Sony, 14 December 2004.

that are needed to conduct the franchised business according to the required methods and standards.

In recent years, franchising activities have become increasingly popular and have expanded into many business fields, big and small; they have also spread in number and on a global scale, as illustrated in table 2.1.

In some cases, the franchised products have to be customized to take into account sensitive cultural aspects in the host country.

Table 2.1 The scale of franchising worldwide

Largest franchised companies

	Total franchised partners and company units worldwide, 2004
McDonald's	30,300
Yum! Brands *(KFC, Taco Bell)*	29,300
7-Eleven	28,200
Cendant *(Howard Johnson, Avis, Century 21)*	24,600
Subway	22,000
Burger King	11,200
H & R Block	11,200
Jani-King	11,000

Source: International Franchise Association, quoted by *International Herald Tribune*, 29–30 October 2005

Example: Franchising McDonald's in India

It was a big challenge for McDonald's to establish its fast food franchise in India. The reason is that the main ingredient of the flagship meal at McDonald's—the Big Mac—is beef, and the Hindus, who are the majority of the Indian population, do not eat the meat of the sacred cow. Pork could not be taken as a substitute either because there are some 140 million Muslims in India who do not eat pork.

To respond to these cultural food problems, McDonald's created an Indian version of the Big Mac, which is made from mutton. Some variations of the McDonald's menu in India include hamburger made from chicken.

Along with the same kind of cultural concerns, and taking into account that many Hindus are vegetarians, McDonald's presents its menus in India along vegetarian and non-vegetarian lines.

Here it faced a big problem when, in 2001, it was disclosed that the oil used in the cooking of its French fries contained small amounts of beef extract. The company was sued by a group of Indian businessmen for concealing the use of beef in its French fries and had to pay compensation and issue a public apology.[45]

[45] *Source:* Hill, Charles, W. L., 2006, page 125.

2.2.4 Joint R&D; joint product development

In this type of alliance, two or more companies undertake R&D jointly, essentially to pool resources, share costs and risks and speed up market entry. As a rule, joint R&D agreements have a specified lifetime, and the alliance activities can take place either in a separate facility or on the premises of one partner.

Joint R&D agreements may have a pre-competitive nature, for example when they aim at achieving a common protocol for harmonizing operational aspects and, when that objective is accomplished, they separately follow their own product development path as normal competitors in the market. In other cases, joint R&D agreements may go further, to the level of joint product development agreements, in which case the alliance can involve equity participation in the form of a joint venture, as is the case with the alliance envisaged by Nokia and Sanyo for the production of CDMA handsets, and in the example below.

Example: R&D agreement between IBM and AMD

Since December 2002, IBM and AMD (Advanced Micro Devices Inc.) have had a joint research agreement, originally set to expire at the end of 2005 but in the meantime broadened and extended through 2008. The agreement focuses on exploratory research into chip making technologies and aims at achieving smaller and more advanced chips with improved performance and lower power consumption.

The alliance integrates engineers from both IBM and AMD, and the work is implemented at IBM's Research and Development Centre.

For AMD, the alliance should help them compete with Intel in the development and commercialization of the latest semiconductor technology; for IBM, the alliance with a leading chipmaker should accelerate technology advances that otherwise could take much longer to reach the market.

As it happens, the alliance has been more than successful. By 2006, at the time of writing, AMD is stealing market share from a struggling Intel, and Dell have announced their decision to start using microprocessors from AMD in some of their high-end servers, a significant shift from their long-time "Intel-only" policy.

2.2.5 Equity alliances; cross-holdings

Equity alliances represent a form of collaborative arrangement in which at least one of the collaborating companies takes an ownership position in the other partner company, usually in the form of minority holdings. Equity alliances may also involve equity swaps or cross-holdings, in which case each partner takes a certain level of ownership in the other.

Typical equity alliances have been found in the automotive industry, and have also been significant in other industries, from electronics to airlines. The trend is towards forming equity alliances in practically all industries. They help solidify other forms of inter-firm collaboration and, when the ownership stake is large enough, one company may even secure a management position in the other, as can be seen in the example of DaimlerChrysler and Mitsubishi Motors, presented below.

In some cases, equity alliances are precursors of, and end up as, a merger or an acquisition, the alliance allowing the minority shareholder to assess the partner and the value of its technological assets.

Example: DaimlerChrysler and Mitsubishi Motors

In March 2001, DaimlerChrysler and Mitsubishi Motors (MMC) signed a letter of intent to form an alliance in the design, development, production and distribution of passenger cars and light commercial vehicles.

It was agreed that DaimlerChrysler would acquire a 34 per cent equity stake in Mitsubishi Motors through a capital increase and would have representation on the management board of MMC in line with their equity participation. This would enable DaimlerChrysler to be part of the decision-making process at Mitsubishi Motors, which nevertheless would remain an independently managed company.

With this alliance DaimlerChrysler expected to strengthen its presence in Japan and in other Asian markets since MMC has an excellent distribution network throughout Asia, and its share of the global small car segment, including the expansion of the Smart brand. For Mitsubishi Motors, the alliance would mean access to additional resources, with potential economies of scale, and an opportunity to intensify its activities outside Asia, and it would benefit from the envisaged cooperation with DaimlerChrysler in the development of new products, engines and environmental technology.[46]

Under the alliance, Mercedes and Chrysler developed several small cars with Mitsubishi on joint platforms and also invested in common engine technology. But the results were questionable and the alliance ended at the end of 2005 when DaimlerChrysler sold out its stake in Mitsubishi Motors, then struggling with declining sales and a financial crisis.[47]

Equity alliances at centre stage

Recent studies have shown that, of all alliances formed worldwide, the percentage of equity alliances has steadily been increasing. For example, a survey of over 3,000 alliances formed in the period 1997–1999 has shown that 25 per cent were equity-based; in another survey of about 2,500 alliances formed in the period 2000–2002, that percentage rose to 62 per cent.

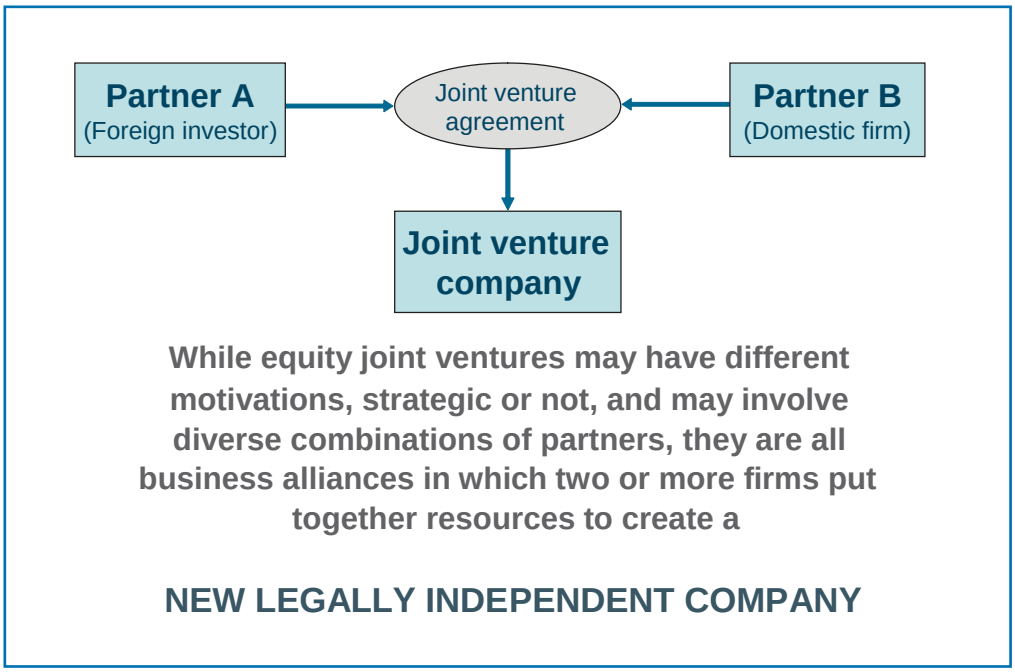
Source: Pekar and Margulis, 2003

2.2.6 Equity joint ventures: the essence of the concept

When dealing with foreign market entry strategies, the concept of joint venture was approached from different points of view. In its broad and generic meaning, joint venture is a "joint business undertaking" and can therefore be regarded as encompassing the various types of business alliances. But from a more focused perspective—adopted by most authors and the one taken in this package—the term joint venture applies to the long-term participation of two or more companies in an enterprise in which each

[46] *Source:* Press release, 27 March, 2000.
[47] *Source: BusinessWeek Online*, 11 November, 2005.

Figure 2.2 The essence of equity joint ventures



party contributes assets, has equity participation, and shares managerial responsibilities and risk. In this sense, a joint venture implies the creation of a new legal entity by the incorporation of the partnership into a new body with a legal and physical existence of its own, and sometimes called "incorporated joint venture" or "equity joint venture".

Joint ventures may involve diverse combinations of partners and different underlying motivations. As examples of the diversity of partners: joint ventures can be formed by two or more companies of the same or different countries joining together in a third country; or by a foreign company and a local company in a host country; or by a foreign company and the host government or a government-owned company in the host country, and so on.

Motivation may also vary: there are joint ventures based on strategic objectives, usually in fast-moving technology areas and involving partners from leading industrialized countries, as is the case of the joint venture between Nokia and Sanyo in the field of CDMA technology, mentioned above; and there are joint ventures established between foreign companies and local partners in developing countries—traditional joint ventures—which aim at setting up manufacturing activities or services in the host country, or take advantage of locally available manpower or natural resources. As a rule, such joint ventures have a great deal of host government involvement in their formation. They can be regarded as conduits of foreign direct investment (FDI) and will be the subject of detailed examination in part 3.

2.2.7 Other types of joint ventures

As well as the typical equity joint ventures described above, and for the sake of providing the most comprehensive overview of the concept, we will review here other types of business alliances that can be categorized as joint ventures. One of them (contractual joint ventures

or consortia) has already been referred to in part 1. Two new categories (cooperative joint ventures and restructuring joint ventures) will now be introduced and, with these, a comprehensive picture of the joint venture concept can then be depicted as follows:

Consortia (or contractual joint ventures). As we have already discussed in part 1, consortia or consortiums are identified, according to some sources,[48] as "joint ventures where more than two organizations participate", and in the classic literature we often find the term "contractual joint ventures" as another way of designating consortia. But, in a more currently accepted concept, the term consortium is used to designate short- to medium-term alliances set up to implement time-limited projects.

Typical cases of consortia appear in the field of civil engineering, and the construction, building, and equipment supply industries, where contractors decide to join forces for a limited period of time in order to jointly build a plant or an infrastructure facility. The channel tunnel between Britain and France was built by a number of construction companies which formed a consortium called Trans Manche Link (TML), which was dissolved on completion of the project.

Consortia are also found in industries where costs and risks associated to research and development work lead multiple companies to form partnerships in order to achieve a common objective, for example, in the pharmaceutical industry, where a new drug can cost $US800 million to develop and bring to market; in the aircraft industry, in the formation of the Airbus Industries consortium for the European production of commercial jets; in information and communication technologies, with consortia for the creation of new generations of computer chips, or the development of advanced wireless communication system.

Cooperative joint ventures (or mixed joint ventures)[49] These are joint ventures between an international company and a developing country government. They are worth being described, even if superficially, because they have distinctive features compared to equity joint ventures. The fact that one of the partners is the government (or a government agency, or a government controlled company) allows for the negotiation of conditions that would not be achievable under the legislation applicable to private business transactions.

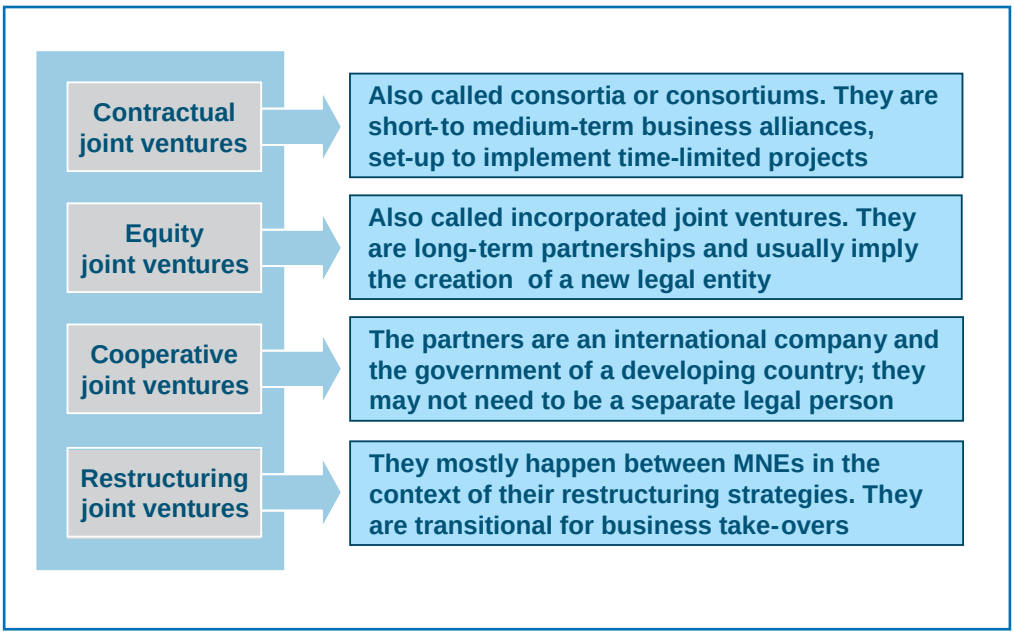
Compared to equity joint ventures, cooperative joint ventures may not need to be a separate legal person (this depends on the host country legislation) but may also expose the foreign partner to greater liability because, in an equity joint venture with a legal person status, the parties' liability is limited to their equity investment. Another problem related to cooperative joint ventures is that all contractual details (which in equity joint ventures would derive from the country's joint venture law) have to be negotiated per se and this makes the proceedings more complex and time consuming.

However, foreign investors may find advantages in entering cooperative joint ventures because:

- They may be the only way to access restricted sectors, for example when the envisaged activity involves assets that are too costly or too complicated to obtain (e.g. land) or licenses that foreign partners cannot get under the host country's laws;

[48] For example, Daniels, 2004.
[49] *China Business Review* online, *Cooperative Joint Ventures*, Jan–Feb 2005.

Figure 2.3 Joint venture types



- They allow for levels of foreign management and control that would not be permitted in an equity joint venture where such issues would have to be correlated to the proportion of equity participation;
- They alleviate capital contribution difficulties. In cases where the foreign partner's ownership is restricted by the host country's laws but the value of contributed assets (e.g. technology and equipments) has to go beyond the permitted ownership levels, a cooperative joint venture may repay the foreign partner from revenues before profit sharing;
- They may present other advantages, such as
  (a) reducing risks, because the government's involvement in the deal deters non-compliance by the local partner; and
  (b) greater ease and flexibility in renegotiating or modifying terms in the event of unexpected problems during implementation.

Restructuring joint ventures. For the sake of comprehensiveness, we will also have a look at this category, which mostly occurs between MNEs in the context of their restructuring strategies. They are not of so much interest for developing countries but, by introducing them, we can bridge the subject of "strategic alliances" with the subject of "joint ventures" proper.

Restructuring joint ventures have been used creatively in cases where a company wishes to alienate non-core, underperforming business and another company is willing to acquire it for a number of reasons, for example to access its technology or brands or the available distribution networks in markets it intends to enter or improve its position in.

Unlike equity joint ventures, which are formed with long term aims and are intended to last as long as the partners find it viable to maintain them, restructuring joint ventures are designed for a limited duration and to be subsequently taken over by the acquiring company.

A restructuring joint venture has substantial advantages over an outright sale of assets. In an outright sale, the restructuring company would be unable to fetch a price commensurate with the real or potential value of the business intended to be alienated nor would the acquiring company be able to make a proper valuation and worthwhile offer for lack of insider knowledge of all the tangible and intangible worth of the prospective deal.

Through a transitory joint venture phase, the parties can ensure a smooth cooperation, mutual learning and the transfer of all business details and procedures in such a way that, when the purchase takes place, the price arrived at by the parties reflects a sound and realistic assessment. In such a scenario, both parties stand to win. The restructurer will be motivated to give to the buyer as much technical and managerial assistance as is needed to ensure the success of the business and boost its selling value when the time comes; the buyer, in turn, can count on open and unbiased assistance that will reduce uncertainties, lower the risks and learning costs, and make it easier to achieve the successful and profitable operation of the new business.

Review of chapter 2.2

Overview of alliance forms

In many cases of licensing agreements, the licensor and licensee are independent firms; but licensing agreements are also frequently formed between equity-related firms, as in the case of the licensing arrangements between Xerox and Fuji-Xerox, this latter being a joint venture between Xerox and Fuji-photo.

Cross licensing is often undertaken between firms working on R&D related to similar products, in which case the similarity of their objectives and work could lead to duplication of each other's innovations. By cross-licensing arrangements, the firms can achieve synergies and avoid the risk of patent disputes.

The concept of franchising involves the replication of a business concept, but in some cases the franchised products are customized to take into account cultural sensitivities. Franchising activities have become increasingly popular and have expanded to many business fields; they have also shown a growing trend to spread in number and on a global scale.

In the case of joint R&D agreements, two or more companies undertake R&D jointly, essentially to pool resources, share costs and risks and speed up market entry. Joint R&D agreements may represent a pre-competitive alliance, or they may go further, to the level of joint product development, and may also evolve into equity alliances or joint ventures.

At earlier stages, equity alliances were typically found in the automobile, electronics and airlines industries, but they are now increasingly emerging in practically all industries. Recent studies have shown that, of all alliances formed worldwide, the percentage of equity alliances has been increasing steadily.

The term joint venture is used to designate different types of business cooperation involving firms, and sometimes also governments, as partners, but the most traditional form is the equity joint venture. What makes equity joint ventures distinctive from other business alliances is that they imply the creation of a new legally independent company.

Other types of business alliances are currently referred to as joint ventures, namely

(a) contractual joint ventures or consortia, set up to implement time-limited projects;
(b) cooperative joint ventures, where the partners are an international company and the government of a developing country; and
(c) restructuring joint ventures, which occur between MNEs in the context of their restructuring strategies and are a transitional stage for business takeovers.

2.3 Alliance constellations and keiretsu

Both alliance constellations and *keiretsu* are forms of conglomeration of allied enterprises which made their appearance in different historical and geographical contexts. Alliance constellations represent forms of conglomeration that came into being in industrialized countries, and more recently in some sectors (airlines, automobile, telecommunications), as an organized response to competitive pressures. *Keiretsu* is a type of conglomeration which emerged in Japan after World War II and is rooted in the centuries-old *zaibatsu*.

The description of alliance constellations and *keiretsu* presented in the subsequent sections shows that the two types of alliance conglomeration have substantial similarities, although the equity ownership connections in alliance constellations are generally looser than those in the traditional *keiretsu*.[50]

2.3.1 Alliance constellations

Setting up alliances has become normal, indeed almost a fashion, in corporate strategy. In many cases, alliances are short-lived and result in premature termination because of inadequacies in the planning and design phase, or a lack of capability to manage and steer the alliance in a way that keeps the partners motivated and committed to it, or because changes in the business environment make the alliance irrelevant. This reality brings us to the idea that what characterizes many alliances—and appeals to the partners—is the flexibility that can be associated to their formation, termination, or adjustment to evolving circumstances.

It is also a fact that, in the present conditions of global competition, many enterprises feel they need to form alliances or become members of established alliances as the only way to achieve what they would otherwise not be able to accomplish alone.

For multinational enterprises in general, an increasing share of their revenues is related to activities involving business alliances, and it is not uncommon for leading enterprises to maintain portfolios of dozens or even hundreds of alliances, either to address their strategies in the different lines of business, or because of the characteristics of specific markets where they may need or find it convenient to operate in association with a local company. Alliances can be established with partners selected on the basis of complementary capabilities, or with suppliers, customers, or even competitors. Indeed, competition has been shifting from rivalry among individual enterprises to rivalry among more and more groups of enterprises.

Such rivalry brings us to the concept of the alliance constellation, which is distinct from the notion of alliance portfolio referred to in the above paragraph.

Competing in constellations has become typical in the airline industry where alliance constellations usually include the following areas of collaboration:

- code sharing, i.e. selling seats on each other's flights;
- coordination of flight schedules, so that passengers can connect between partners' flights with a single ticket and minimum delay;

[50] *See* Glossary.

- check-in services for alliance partners and luggage routing to final destination;
- integration of frequent flier programmes;
- access by premium passengers to all members' airport lounges.

This collaboration among alliance constellations partners in the airline industry can also include joint marketing, inventory management, procurement and sales and, in the quest for increased efficiencies, even adopting common standards for joint aircraft purchases.

Alliance portfolios versus alliance constellations

In an alliance portfolio, set up and maintained by a leading enterprise, there might be different alliances or groups of alliances, e.g. built up around different activities or range of products, but those alliances or groups of alliances remain unrelated to each other.

An alliance constellation, also referred to by some authors as alliance group or strategic network, is a group of alliances which, altogether, in the design of the alliance architecture and in the interaction between the alliance partners, serves a business strategy shared by all the partners.

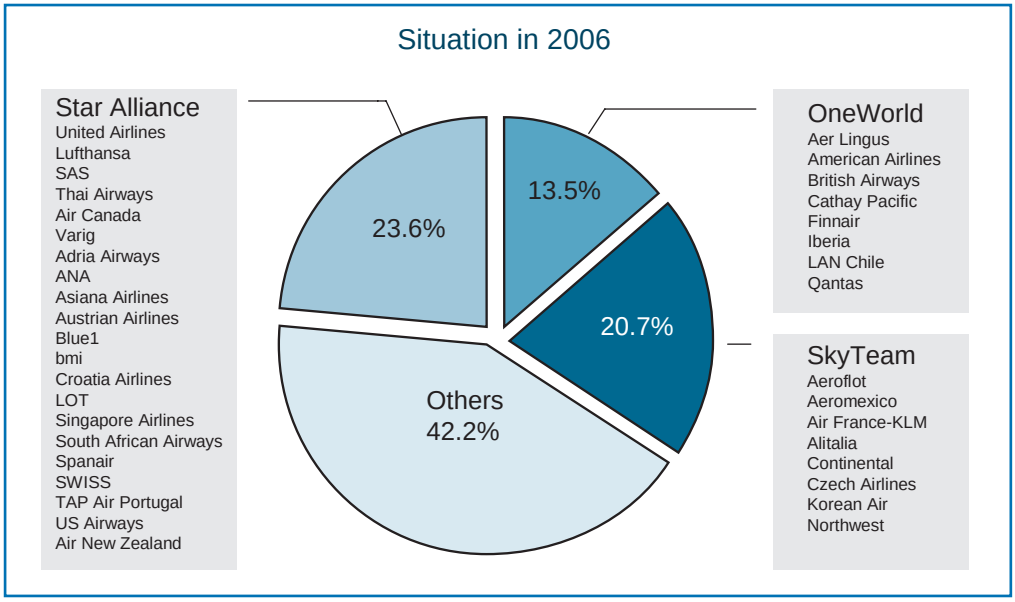
Alliance constellations in the airlines industry have brought together partners with complementary, rather than overlapping, routes and contributed to increasing business, cutting costs, and lifting profits. Within alliance constellations, passengers are supposed to benefit from seamless travel, better connections, more airport lounges and greater frequent-flier benefits. Empirical evidence seems to show that air fares have become cheaper, at least in some routes, but some analysts argue that the alliances may result in higher prices for passengers on those routes where the alliance achieves a dominant position and stifles competition.

During the 1990s, there was a rapid growth of bilateral alliances in the airline industry, mostly in the form of code-sharing. By 1999, the number of such alliances was about 500.[51] But the 1990s had also witnessed a lot of instability and fragility in the airlines industry, with many of those alliances falling apart and with shifting partnerships by some major players. Since the late 1990s, the industry has been coalescing around a small number of alliance constellations, the three biggest (Star Alliance, Skyteam Alliance and Oneworld) accounting for about two thirds of global air travel (*see* figure 2.4).

Other sectors or markets where alliance constellations have emerged and grown (although some high profile alliance constellations have been short-lived) are those requiring the convergence of multiple technologies, for example personal digital assistants (PDAs), or those using multiple components and depending on multiple supply alliances, for example the automobile industry, or those depending on a collection of allies or sponsors to survive and prevail in standards battles and to reach different customer sets, for example computer software and telecommunications.

[51] *The Economist*, 15 July 1999.

Figure 2.4 Major alliance constellations in the airlines industry



Source: Wikipedia.

2.3.2 Keiretsu

Keiretsu is a Japanese term that designates conglomerations of companies organized around a major bank and linked together by interlocking business relationships and shareholdings. The *keiretsu* represent a transformation of the former conglomerates, known as *zaibatsu*,[52] which controlled Japanese industry before World War II and were dismantled by the Allies during the post-war occupation because they were regarded as antidemocratic concentrations of power. In a typical *keiretsu*, a bank holds shares of the commercial companies that form the *keiretsu*, and the latter have cross-holdings among themselves; in addition, high-level managers of the conglomerated companies maintain long-term personal relationships and the same person often serves as director on different companies' boards. *Keiretsu* member companies cooperate with each other in many areas of common and complementary interests, for example providing financial assistance to each other, sharing market intelligence, procuring raw materials and exchanging technology. In general terms, *keiretsu* contribute to the improved competitiveness and increased market share of their members.

Although *keiretsu* take the form of horizontally-integrated alliances across different industries (an essential distinction from *zaibatsu*, vertically-integrated by nature), some *keiretsu* members also act as suppliers to each other, which may bring to the *keiretsu* some degree of vertical integration.

The "Big Six" Japanese *keiretsu* are shown in table 2.2. It can be seen that different *keiretsu* can have the same leading bank. The reason is that, as a result of the Japanese recession of the 1990s, the banking sector was hit by bad loan portfolios and many large banks were forced to merge as an alternative to bankruptcy. For example, Sumitomo Bank and Mitsui Bank became Sumitomo Mitsui Bank, and Sanwa Bank became part of Mitsubishi UFJ Bank. As a result, the boundaries between the various *keiretsu* have become somewhat diluted.

[52] *See* Glossary.

Table 2.2 The "Big Six" Japanese *Keiretsu*

Name of *keiretsu* and leading banks	Major group companies
Mitsubishi (Mitsubishi UFJ Bank)	Kirin Brewery, Mitsubishi Electric, Mitsubishi Fuso, Mitsubishi Motors, Nippon Yusen, Shin-Nippon Petroleum, Tokyo Marine and Fire Insurance
Mitsui (Sumitomo Mitsui Bank)	Fuji Photo Film, Mitsui Real Estate, Mitsukoshi, Suntory, Toshiba, Toyota
Sumitomo (Sumitomo Mitsui Bank)	Asahi Breweries, Hanshin Railway, Keihan Railway, Mazda, Nankai Railway, Sumitomo Real Estate
Fuyo (Mizuho Bank)	Canon, Hitachi, Marubeni, Matsuya, Nissan, Ricoh, Tobu Railway, Yamaha
Dai-Ichi Kangyo (Mizuho Bank)	Fujitsu, Hitachi, Isuzu, Itochu, Tokyo Electric Power
Sanwa (Mitsubishi UFJ Bank)	Hankyu Railway, Keisei Railway, Kobe Steel, Konica Minolta, Kyocera, Orix, Shin-Maywa, Takashimaya, Toho

There are other important *keiretsu*, for example in the automotive industry (Toyota Group, Nissan Group, Honda Group, etc.) and in the electronics industry (Hitachi, Toshiba, Sanyo, Matsushita, and the respective affiliates).

Although the *keiretsu* concept and organizational model is a typical Japanese creation, some forms of conglomeration that came into being outside Japan have comparable features to those of *keiretsu*, as, for example, the following:

The Virgin Group. This is a conglomerate built around the Virgin brand and led by Virgin Atlantic Airways, complemented by its low-fare associates Virgin Express (pan-European) and Virgin Blue (Australian). In addition, the Virgin Group also operates a varied set of companies and businesses in which it has minority or majority holdings, such as music, videos and computer games, megastores, cosmetics, financial services, health clubs, mobile phone services, among others.[53]

The Tata Group. Founded as a textile trader by Sir Jamshedji Tata more than a century ago, this group has grown and diversified its operations over the years. At present, it comprises more than 90 companies in seven business sectors, namely engineering, material, energy, chemicals, services, consumer products, and information systems and communications. The group is controlled by the holding company Tata Sons, and among its main operations are steelmaking, through Tata Steel Limited, and vehicle manufacturing, through Tata Motors Limited.

Kleiner, Perkins, Caufield and Byers (KPCB). The name comes from the founding partners, all of them with senior industry experience. KPCB was formed in 1972 as a

[53] *Source:* www.hoovers.com

venture capital firm and, as such, has been an investor in more than 300 firms. Its investment portfolio comprises many independent companies in different business sectors (and operating in a manner similar to *keiretsu*), particularly in the fields of information technology and biotechnology. Among the participating companies we can count fast-growing dot-com and high tech stars like Amazon.com, America Online, Flextronics, Genentech, Google, Netscape, and many others.

Review of chapter 2.3

Alliance constellations and keiretsu

Alliance constellations and *keiretsu* made their appearance in different historical and geographical contexts. They are types of alliance conglomeration with substantial similarities, although the equity ownership connections in alliance constellations are generally looser than in the traditional *keiretsu*.

Alliance constellations and alliance portfolios represent distinct concepts. An alliance constellation is a group of alliances which, altogether, serves a business strategy shared by all the partners. An alliance portfolio is set up by a leading enterprise around specific activities or products, and the various alliances remain unrelated to each other.

Alliance constellations in the airlines industry have brought together partners with complementary, rather than overlapping, routes. This has resulted in better connections and minimum delays; and contributed to increasing the business, cutting the costs and raising the profits of the partner companies.

Other sectors where alliance constellations have emerged are those requiring convergence technologies, for example PDAs, or needing multiple supply alliances, for example the automobile industry, or depending on many allies or sponsors, for example computer software and telecommunications.

Keiretsu is a Japanese term that designates conglomerations of companies organized around a major bank and linked together by interlocking business relationships and shareholdings. The *keiretsu* represent a transformation of the former conglomerates, known as *zaibatsu*, which controlled Japanese industry before World War II.

Keiretsu members cooperate with each other in many areas of common and complementary interests, for example procurement, technology exchanges and sharing market intelligence.

The Japanese recession of the 1990s led to the restructuring of the banking sector, with mergers among large banks and the consequent dilution of boundaries between *keiretsu*.

2.4 Strategic alliances

2.4.1 Characterization of strategic alliances

Any attempt to clarify the meaning and boundaries of the term strategic alliance will face the kind of problems encountered when trying to define the concepts of alliances and business alliances. In major reference works we find hardly any uniform and consistent definitions of strategic alliance, and many sources use that term in the same broad and encompassing way as the terms alliance and business alliance.

However, an indepth review of business literature also shows that leading authors do make a distinction between the term alliance (used in a generic way and applied to a multitude of business relationships from simple and loosely structured ones to complex constructions involving heavy and legally binding commitments) and the term strategic alliance (a term used more selectively to designate alliances sought by the partners to respond to needs or pursue objectives that are related to their strategic business intentions).

Strategic alliances: fluidity of the concept

Some authors use the term strategic alliance in a very generic way and apply it to almost all forms of business relationships; others are more selective and apply the term to situations where the partners have a clear strategic business intention.

Some of the cooperative arrangements or alliance forms enumerated in section 2.2 above are usually regarded as strategic alliances. Such is the case with joint R&D and equity alliances. Other types of inter-firm cooperation may or may not fall into the category of strategic alliances.

The following examples are intended to illustrate this reality and provide additional insight to the concept of strategic alliance as we see it for the purpose of this package:

(a) Let us consider the licensing of a mature technology, or a technology reaching the declining phase of its life-cycle curve,[54] the motivation of the licensor being to seize an opportunity to get some additional income, and the aim of the licensee being to produce for the local market as an alternative to importing the licensed items. In this case, we have a tactical move embodied in a contractual relationship which we categorize as a strategic alliance.

The licensing agreement between Xerox and Fuji-Xerox has substantially different characteristics. In this case, the partners are both technologically advanced firms, and the agreement appears in the context of a broader and more dynamic cooperation aiming at long-term positioning, sustaining the competitive advantage and market expansion of the licensed products in strategic countries, namely

[54] *See* Glossary.

in Asia. In this case, the licensing agreement and all contractual elements associated to it can thus safely be regarded as a strategic alliance.

(b) Let us now consider the example of joint ventures. In the case of the joint ven(ture between Nokia and Sanyo, both companies have been struggling and losing money in the CDMA handset business as each of them alone has been unable to achieve technological leadership and increase market share. The joint venture means bringing together technology and financial resources as well as commitment by the partners to joint development efforts in order to become major players in a highly competitive field. This kind of joint venture can easily be perceived as a strategic alliance.

Alliances: to be or not to be strategic

Licensing agreements and joint ventures may or may not be categorized as strategic alliances.

Licensing: as an alternative to export: usually non-strategic but as in the case of Xerox with Fuji-Xerox: strategic

Joint ventures: in developing countries: usually non-strategic as in the case Nokia with Sanyo: strategic

In contrast, many joint ventures involving international companies and partners of developing countries (or government agencies of developing countries) are not regarded as strategic alliances since they do not usually involve strategic development motivation or inputs of a strategic nature. As a rule, they aim at manufacturing activities in the host country (for the domestic market or for targeted markets) by using mature technologies. The domestic partner's contribution is often related to their knowledge of the local market, their links to local enterprises and government institutions, and their ability to smooth labour relations and handle regulatory issues. Of course, one could argue that such joint ventures—or business alliances—could also be regarded as strategic, but, despite the blurs in the definitions, most authors and sources consider joint ventures in general, and traditional joint ventures in particular, as substantially and substantively different from strategic alliances, as will be explained in subsequent sections.

What then are the common features of strategic alliances?

Strategic alliances are agreements involving two or more partners, including the corresponding organizational and legal constructs, which are of critical importance for the competitive viability of one of the partners, or aim at strengthening the competitive position of both partners, or are intended to improve the long-term positioning of their products in the market.

To be successful, strategic alliances require that the partners are willing and motivated to undertake a dynamic cooperation, including the sharing of core competencies. Additionally, what is typical of strategic alliances is that in some sense they are "incomplete

Characterization of strategic alliances

- May involve two or more partners who cooperate dynamically and share some of their resources and capabilities;
- Aim at developing additional resources and capabilities as a foundation for new and strengthened competitive advantages;
- Require close monitoring, and flexibility and openness to redefine objectives according to changing circumstances;
- Can take place between competitors in the same business.

contracts",[55] involving on-going contributions towards moving targets and requiring from the partners an openness to change course, redefine objectives and re-allocate inputs according to the evolving realities in the alliance life. By the same token, the partners should recognize the situations where the alliance does not meet the expectations that led to its formation and put a natural end to it before too much acrimony or injury builds up in the partners' relationship.

Strategic alliances can take place between competitors in the same business. In fact, it is not uncommon that alliances of this kind end-up in a process of merger and acquisition either by the predetermined intent of one of the partners or because changing circumstances may naturally lead to such an outcome.

Example: Bayer AG and Schering-Plough

In September 2004, the German Bayer AG was facing problems with its pharmaceuticals business and, in a process of transformation and cost savings, set up a marketing and sales alliance with the US drugmaker Schering-Plough. The latter company would take over US sales of Bayer antibiotics Avelox and Cipro, blood pressure treatment Adalat, and impotence treatment Levitra. The deal would result in 1,800 job cuts at Bayer and a 75 per cent cost reduction in its pharmaceutical operations in the United States. For its part, Bayer would sell some Schering-Plough cancer products in Europe, and the two companies would jointly sell the Schering-Plough Zetia cardiovascular drug in Japan.

In March 2006, Bayer announced a takeover bid of $US20 billion for rival drug manufacture Schering. At the time of writing, the deal is contingent upon Bayer's acquiring 75 per cent of Schering's voting rights and winning approval of US and European antitrust regulators.

2.4.2 Reasons to develop strategic alliances

Strategic alliances have become an indispensable element in the strategies of multinational enterprises. In the present competitive environment, these enterprises face a variety of new factors, including increasing R&D costs, shortening product life cycles, growing barriers to market entry, an increasing need for global-scale economies, and

[55] *Source:* Bamford, Gomes-Casseres and Robinson, 2003.

the ever-increasing importance of global industry standards. Even big global companies recognise that many resources they needed to remain competitive and grow have to be obtained outside their boundaries. This recognition has led to the propensity of MNEs to form strategic alliances with other firms with complementary resources and even with their global competitors.

It is to be noted that strategic alliances, inasmuch as they aim at the creation of new products, technologies and services, mostly occur in industrialized countries and between firms with balanced core competencies and comparable innovative capabilities. This is one factor (there are others as we will see below) that differentiates strategic alliances from traditional joint ventures, which are formed between a multinational enterprise from an industrialized country and a local partner in a developing or less-industrialized country, usually to expand the market for existing products.

The key motivations for the formation of strategic alliances are:

Technology exchange

There is a higher proliferation of strategic alliances in industries with a pattern of rapid change, technology intensity, short product life cycles and multiple dependencies in their value chains. This is the case with telecommunications, information technology, electronics, pharmaceuticals, biotechnology, entertainment, airlines and financial services, among others. These are sectors where major innovations and breakthroughs involve very costly and hazardous R&D efforts under time pressure, and require interdisciplinary and inter-industry advances. The solution for such strategic challenges lies in technology exchange among different firms, including joint R&D.

Global competition

The competitive advantage achieved by multinational enterprises nowadays is based on complex webs of relationships in the form of global value chains and global production networks. This means that the basis of global competition is no longer

Drivers and motives for strategic alliances

- Acquisition of technology and joint R&D for major innovations and market advantage;
- Assembling of complementary resources to achieve or improve global competitiveness;
- Industry convergence requiring interdisciplinary skills and inter-industry cooperation;
- Risk reduction when development costs are very high and results are uncertain;
- Access to markets when governments' policies demand alliance with a domestic firm;
- Co-opting competitors or teaming up against a particular competitor.

"companies against companies" but "groups of companies competing against groups of companies". The formation of strategic alliances entails the same rationale and motivation of enabling the alliance partners to achieve or improve global competitiveness, in particular when they face a well-established global market leader or strong coalitions of competitors.

Industry convergence

The boundaries of many industries are increasingly overlapping or becoming blurred. Just to mention a couple of illustrative examples, computer, telephone and video camera technologies are intersecting, and advanced materials are finding applications in diverse fields like the aerospace and automotive industries and in medicine. The way to cope with the complexity of the situation and assemble the necessary interdisciplinary and inter-industry skills is collaboration through cross-industry strategic alliances involving the relevant players. This will allow for the development of new industry segments and innovative systems, and possibly new industry standards, which can isolate other players and act as a barrier to potential entrants.

Risk reduction

R&D costs for developing new products in industries such as pharmaceuticals, automobiles, information technology and aircraft can be very high, deterring individual companies from undertaking projects, either because of the high cost of development or because of the long payback period to recover their capital investment. The development costs of a new aircraft, for instance, can run to several billion US dollars and it may take more than ten years to recover the initial investment if the product is successful. Sometimes, where the risks of development are too high for even a cooperative agreement between large firms, the government supplies some of the financing.

Access to markets

Entering a foreign market can be risky, especially where the socio-political climate is unfamiliar or government policies restrict entry in some sectors, except where the foreign firm undertakes an alliance with a local firm. When McDonnell Douglas wanted to enter the Chinese market, it had to form an alliance with China's Shanghai Aircraft Industrial Corporation, with McDonnell Douglas providing the technology and the Chinese partner providing access to the large Chinese market. The agreement required that Chinese scientists and engineers work with the American company on new aircraft design.

Co-opting or blocking competition

Strategic alliances are often used as a means to co-opt competitors by making agreements with them, or to block competition by teaming up with one or more competitors to form a united front against a particular firm. For example, Phillips and Matsushita set up an alliance aimed at sharing technology on digital audio tapes in an attempt to prevent Sony mini disk technology from becoming the industry standard in music technology. When such cooperative agreements involve firms with large (and dominant) shares of the market, they may also try to set artificially high prices by setting up a cartel. Such arrangements may be illegal under antitrust legislations.

Example of antitrust violation: For drug makers and consumers alike, collaboration can sometimes be a costly problem. In September 1999, three Japanese drug makers—Takeda Chemical Industries, Eisai, and Daiichi Pharmaceutical—agreed to plead guilty to U.S. antitrust violations and pay some $US137 million in what U.S. Justice Dept. officials say was a global price-fixing conspiracy over vitamins. In the spring of the same year, Switzerland's F. Hoffman-LaRoche and Germany's BASF agreed to pay some $US725 million for their alleged roles in the conspiracy.

Source: BusinessWeek, October 25, 1999.

2.4.3 Costs and risks of alliances

Although the notion of strategic alliance suggests the pooling of complementary skills and resources to achieve a common purpose, the fact is that in many cases the partners are also competitors outside the specific purpose of their collaboration. Consequently, it may happen, either by design or by the natural course of events in the alliance's life, that the learning process and the benefits of partnership evolve asymmetrically to the parties in a way that changes their relative competitive positions. In some cases, which are not the rule, one of the partners enters the alliance with the deliberate intent of undermining the other party's competitive position. This is what we can call predatory tactics. Also, in many cases, a major aim of each of the alliance partners is to learn as much as possible from the other partner, continually assess the benefits reaped from the alliance, and eventually discard the partner and leave the alliance when there is no further room for value appropriation.

Example: When General Foods entered into a partnership with Ajinomoto, the Japanese food giant, it agreed to make available its advanced processing technology for products such as freeze-dried coffee. In return, its Japanese partner would contribute marketing expertise to launch the new products on the Japanese market. After several years, however, the collaboration deteriorated and was eventually dissolved when Ajinomoto had absorbed the technology transferred from General Foods, and its management felt it was no longer learning from its American partner. Unfortunately, General Foods had not done such a good job of learning about the Japanese market and left the alliance with some bitterness.

Source: Bartlet, Ghoshal, Birkinshaw, 2003.

Asymmetries in learning from the alliance may occur when the skills and competencies of one partner are mostly tacit and embedded in complex organizational processes (difficult to unveil and capture) and those of the other partner are embodied in tangible elements like technical specifications or machines, which can easily be understood, reverse-engineered and replicated.

2.4.4 Organizational complexity

The motivation, the understanding of the rationale behind the strategic choices, the negotiations and the decisions related to the creation of a strategic alliance rest at the highest managerial levels of the participating companies. However, the implementation of the alliance's operations is in the hands of teams or a task force of researchers and professionals assigned by each partner, who have to work together and also coordinate alliance-related tasks within their own enterprises. These circumstances may result in substantial complexity and difficulty for the alliance. The alliance staff may not fully understand what is at stake and the risks involved and may expect rewards; moreover, they come from different companies (and, as a rule, from different countries) with different social and cultural backgrounds, and with different corporate cultures, value systems, organizational structures, managerial mentality, reporting practices and so on. Issues of divided loyalties may arise, given that the partners in the alliance are also competitors, and the alliance staff has to balance the rightful inputs to achieve the common purpose and the areas that should be kept off-limits to the other partner. Comparable problems may also surface at the highest managerial level throughout the life of the alliance. There is substantial evidence that in strategic alliances between Japanese and Western partners (in particular with U.S. partners) problems have been associated to cultural factors and to different perspectives on and expectations of the alliances' outcomes. In general, Western partners seem to be more concerned with shortterm results and their impact on the value of their stock—the accounting mentality—while the Japanese partners typically pursue longer term objectives through learning as much as possible from their counterparts.

Strategic alliances: some issues

- Decision to create alliance rests with senior management but implementation is in the hands of operational professionals, who may not be fully aware of the underlying motivations;
- Alliance staff come from different corporate structures and value systems, and even from different countries and distinct cultures;
- Alliance members may also be competitors, which may raise questions about the extent and depth of inputs to be provided to the alliance;
- The partners may enter the alliance with different perspectives, e.g. long-term (focus on learning) vs. short-term (focus on results).

These complexities and issues require special attention and management time to avoid misunderstandings and the collapse of the alliance. The managerial approaches and functions in traditional joint ventures, as we have seen and will explore further, are well defined by the partners at the outset and can remain stable and predictable over time. But in strategic alliances there are many areas of potential conflict; there is a natural rivalry between the partners, and changing conditions and scenarios of uncertainty are inherent in this kind of partnerships. Consequently, strategic alliances have to be permanently monitored and subjected to corrective actions to enable them to overcome problems and steer a course according to the changing conditions.

2.4.5 Learning and knowledge flows

In an alliance there are always flows of information across the boundaries of the participating companies, irrespective of their envisaged objectives. Learning from the other partner is one of the most important outcomes for the alliance participants. There are two important courses of action that they should take in this regard: on the one hand, they should set up mechanisms to maximise their learning from the partnership and, on the other, they should be careful to prevent the disclosure of sensitive and proprietary knowledge that was not intended to be shared and has to be protected, so that their competitive position will not be undermined, nor the balance of the alliance shifted to the other partner.

In order to allow for the envisaged appropriation of knowledge, companies should select appropriate interface managers, familiar with the issues related to information flows, conversant with the company's internal organizational processes, with status and credibility at the various managerial levels and in the different parts of the company, and able to ensure that the relevant information flows along the right path and is properly used within their company.

The well-known NUMMI partnership between GM and Toyota illustrates this challenge. Located in Fremont, California, NUMMI quickly became one of the most productive auto plants in North America. Yet, despite the active involvement of hundreds of GM managers in running the plant and GM's stated intention of learning from Toyota, the American partner never created an effective mechanism for transferring the knowledge gained in NUMMI to other GM plants.

2.4.6 Strategic alliances as an alternative to mergers and acquisitions

The objectives that lead firms to form alliances can sometimes be achieved through mergers and acquisitions, which are also popular ways of sustaining competitive advantage, acquiring advanced technology resources, developing new products and entering new markets. In many cases, alliances are regarded as more advantageous than mergers and acquisitions. Mergers involve huge financial outlays, complex negotiations, irreversible commitments and sometimes deep structural and managerial adjustments. As for acquisitions, while they allow outright access to a needed resource, they bring with them a package of additional elements that the acquirer has to pay for, and may represent more of a burden and a liability than an asset.

There are also cases where companies create alliances not because they are regarded as the most attractive solution but as an alternative to a merger—which might be prevented by competition laws or by government restrictions. An illustrative case of this is the airline industry, the characteristics of which call for global integration. However, many countries still do not allow foreign ownership of their domestic airlines, so the best available alternative for rationalizing services, cutting costs and achieving economies of

scale is to establish marketing and code-sharing partnerships, as in the cases of Star Alliance, Skyteam Alliance and OneWorld, which were presented in section 2.3.1 "Alliance constellations".

2.4.7 Strategic alliances vs. joint ventures

We have already seen that some strategic alliances may take the form of joint ventures and we have also highlighted the fact that strategic alliances (and the joint ventures categorized as such) are mostly developed in fast-moving technology areas and between firms from industrialized countries with balanced core competencies and innovative capabilities.

Another type of joint venture, as we have also seen, is what we may call traditional joint ventures, usually established between foreign companies and local partners in developing countries, which aim at setting up manufacturing activities or services in the host country, or taking advantage of locally available manpower or natural resources. As a rule, such joint ventures have a great deal of host governments' involvement in their formation. They can be regarded as conduits of foreign direct investment (FDI) and will be the subject of detailed examination in part 3.

Joint ventures are substantially distinct from strategic alliances in a number of ways. These are:

> Unlike strategic alliances, the role of joint ventures is not so central in MNEs' strategies in the development of fundamentally new technologies, products or services. Joint ventures have traditionally been used to achieve economies of scale and scope in well known market segments and by using mature technologies.

In typical joint ventures, the partners pool together resources which are known and quantifiable and share risks and profits which are predictable and assessable; in strategic alliances the initial definition of each partner's contribution is often blurred and can only be sharpened as the alliance's life and the joint development efforts evolve.

> Although joint ventures may involve more than two partners, they are typically bilateral arrangements aiming at a well-defined common purpose based on well-known physical or technological assets. Strategic alliances, in contrast, increasingly bring together multiple partners because their purpose is to develop ever more complex solutions and systems with highly specialized contributions and resources from many sources.

The management of strategic alliances is far more complex and unsteady than the management of joint ventures. In a strategic alliance, adding to the original uncertainty, there is an underlying rivalry between the partners, and a need for continuing

readjustments and eventual reallocation of resources, based on the assessment of actual results achieved in relation to the expectations. All this makes the management of an alliance one of the most sensitive and, perhaps, decisive factors for its success or failure.

To sum up: From the above, we can see that joint ventures and strategic alliances are essentially different types of partnership in terms of:

(a) the motivations and aims of the parties;

(b) the nature of the resources allocated and how these may evolve over time;

(c) the predictability and stability of the relationship;

(d) the issue of collaboration versus competition and rivalry; and

(e) the managerial approaches required.

Having shed some light on the distinct characters of strategic alliances and joint ventures, we could say that the notion of strategic alliances as characterized above (and further described in subsequent sections) usually entails complex forms of cooperation between firms that have leading positions in the market and advanced R&D capabilities and, through the alliance, are pursuing strategic objectives of some sort. In practice, this means that strategic alliances are more likely to occur between MNEs of industrialized countries and rarely to involve enterprises of developing countries with low or intermediate levels of technological capabilities.

For such countries, which represent the core of the UNIDO constituency, joint ventures are more appealing for domestic enterprises as durable and enriching relationships with foreign investors who themselves wish to set up operations abroad and regard the joint venture option as an advantageous FDI conduit. That is why the subject of joint ventures is given a central role in this package. Nevertheless, it was also found opportune and convenient to carry out this broad exploration of the subject of business alliances for the sake of opening as many windows as possible into the complexities of enterprises' lives as they are influenced and shaped by the forces of global competition.

Review of chapter 2.4

Strategic alliances

The concept of strategic alliances varies according to the author. Some authors use the term strategic alliance in a very generic way and apply it to almost all forms of business relationships, while others are more selective and apply the term to situations where the partners have a clear strategic business intention.

As a common definition, strategic alliances are agreements involving two or more partners which are of critical importance for the competitive viability of one of the partners,

or aim at strengthening the competitive position of the partners, or are intended to improve the long-term positioning of their products in the market.

What characterizes strategic alliances is that they:

(a) may involve two or more partners who share some of their resources and capabilities;
(b) aim at achieving new and strengthened competitive advantages;
(c) require close monitoring, flexibility and openness in order to cope with changing circumstances; and
(d) can take place between competitors.

Licensing agreements and joint ventures may or may not be categorized as strategic alliances. Licensing as an alternative to export is usually non-strategic but, as in cases like Xerox with Fuji-Xerox, it has a strategic nature; joint ventures in developing countries are usually non-strategic but, in cases like Nokia with Sanyo, can be regarded as strategic.

Strategic alliances have become an indispensable element in the strategies of multinational enterprises, allowing them to cope with a variety of new factors, including increasing R&D costs, shortening product life cycles, growing barriers to market entry, an increasing need for global-scale economies, and the ever-increasing importance of global industry standards.

In a strategic alliance there are always flows of information across the boundaries of the participating companies, irrespective of the envisaged objectives. Learning from the other partner is one of the most significant outcomes for the alliance participants, but also raises important issues related to the disclosure of information.

While the partners should set up the mechanisms that could maximise their learning from the partnership, they should also be careful to prevent the disclosure of sensitive and proprietary knowledge that is not intended to be shared and has to be protected to avoid undermining their competitive position or shifting the balance of the alliance to the other partner.

The objectives that lead firms to form alliances can sometimes be achieved through mergers and acquisitions, which are also popular ways of sustaining competitive advantage; but, in many cases, alliances are regarded as more advantageous than mergers and acquisitions.

Strategic alliances and traditional joint ventures are essentially different types of partnership in terms of:

(a) the motivations and aims of the parties;
(b) the nature of the resources allocated;
(c) the predictability and stability of the relationship;
(d) the issue of collaboration versus rivalry; and
(e) the managerial approaches required.

3 Implementing joint ventures

3.1 Joint ventures in developing countries: a conduit of foreign direct investment

3.1.1 Historical overview

Bearing in mind the intended users of this training package, the type of joint venture we are mostly concerned with is the equity joint venture implemented in developing countries and having as partners a foreign company (which we will also and interchangeably designate as foreign investor or foreign partner) and a domestic company (which we will also and interchangeably designate as local company or local partner). The foreign company is, in many cases, a multinational enterprise and the local partner can be a private company or a public company or a government institution.

Joint ventures in developing countries: a tripartite concern

The success of a joint venture in developing countries depends on a convergence of interests involving three parties, namely the foreign investor, the domestic company and the host government. They are usually established as long-term agreements with a horizon of between 10 and 30 years; sometimes the parties do not even provide a time limit for their duration, assuming that the undertaking will run for as long as the business is viable and profitable.

Historically, joint ventures in developing countries came into wide use after World War II as a new form of foreign direct investment (FDI). At earlier stages of international expansion, enterprises from developed countries used to set up operations abroad through wholly-owned subsidiaries. After World War II, investors from developed countries willing to extend their operations into newly independent developing countries started to search for local partners, for a number of reasons:

(a) Local partners were considered an asset in establishing new businesses in the host country since they could better solve problems inherent to the local regulatory environment and could also give a more favourable local image to the foreign investor.

(b) Local entrepreneurs themselves were eager to upgrade their operations through the acquisition of the foreign capital, know-how and technical skills which foreign investors would bring with them.

(c) Host country governments were also active players in the formation of joint ventures between foreign companies and local partners because FDI used to be tightly regulated and their foreign investment codes in those days would usually favour the joint venture option as a pre-condition to allow business or manufacturing operations by foreign companies in the country.

Since the 1980s, the attitudes of developing countries to foreign direct investment have changed substantially. The previous restrictive positions gave way to increasingly liberalized policies. This trend was the result of several factors, among which we can count the

pressure of multilateral and bilateral trade agreements, the conditions imposed by international financial institutions in connection with structural adjustment programmes, and also the adherence by governments of developing countries to the idea that foreign direct investment had a positive contribution to make to industrial development and economic growth.

In recent years, other realities in the field of international business operations and foreign direct investment have come to light. While traditional foreign investors used to be large multinational enterprises from industrialized countries, nowadays we are witnessing the emergence of new players and also a shift in the sector composition of FDI, as presented below and illustrated in table 3.1:

(a) *Large multinational enterprises from developing countries.* These have been increasing in number, in size and in boldness of operations. They reflect the rapid technological development that is occurring in some emerging economies, where firms have been able to learn, innovate and create their own brands to the point of becoming global players themselves. To take just a few examples, we can think of SABMiller (South Africa, beer and beverages), Huawei (China, telecommunications equipment), Infosys (India, IT and business outsourcing services), Cemex (Mexico, cement manufacturing and delivery).

(b) *Small multinational enterprises.* Nowadays, globalization is not the exclusive domain of large multinational enterprises. Small and medium-sized enterprises, from industrialized countries and developing countries alike, may also follow the internationalization path and become multinational. Such development could result from the participation in global value chains of large multinational enterprises and the consequent upgrading of competencies and learning about opportunities in foreign markets; saturated home markets and the pressure of competition may also drive such firms to pursue foreign markets and also to invest abroad to take advantage of locational advantages, such as low labour costs, tax incentives, easier access to regional markets and so on.

(c) *Private equity funds; private equity firms.*[56] In the last twenty years, "private equity" has evolved from being a practically unknown and marginal activity into a respectable mature industry. Private equity firms play an important role as investors, not only in industrialized countries but also in developing countries, where they can be an effective vehicle for the upgrading of local companies. In fact, the most typical ways for private equity firms to generate profit for their partners are to buy shares in private companies and sell them later at a higher price (e.g. through an initial public offering or a sale to other investors) or to engage in buy-outs of established public companies in order to have them restructured, upgraded and sold at a profit after a certain period, usually 5–8 years. An important feature of the private equity firms' operations is therefore that they are expected to improve the performance of the companies they buy. Another feature is that private equity firms have been active in attracting the best available leaders and specialists in the business, political and cultural environments. As a consequence of these features, companies acquired or participated in by private equity funds benefit from strategic advice and access to networks of management talent and industry expertise that are needed to successfully develop their global strategies.

[56] *See* Glossary.

Table 3.1 Shift in the patterns of foreign direct investment

FDI: Players and evolution

Period	Players	Targets
Early stages of multinational expansion	MNEs, TNCs from industrialized countries	Extracting industries (originally) Manufacturing (subsequently) Services (at a later stage)
1980s onwards	Small MNEs (internationalized SMEs)	Manufacturing and services
1980s onwards	Private equity funds	Acquisitions (partial or total), upgrading (of acquired enterprises) and sale (with a profit)
1990s onwards	MNEs from emerging economy countries	Extracting industries Manufacturing Services

(d) *The shift to services.* While extracting industries and manufacturing activities were dominant in the earlier forms of FDI, in the past two decades there has been a significant shift towards the service sectors. This was driven by several factors. First, it reflects a general trend in industrialized countries (the main source of FDI), which have increasingly moved away from manufacturing and toward the services industries. Second, developing countries liberalized their FDI regimes, allowing foreign investors to take ownership of business enterprises in previously restricted sectors, such as telecommunications and financial services. Third, unlike manufacturing industries, where know-how and technology can be licensed across borders with no need of direct investment, services can hardly be traded in that way. Services like retailing, financing and telecommunications have to be generated within the markets they address. So, if a services firm wishes to take advantage of business opportunities in a foreign country, the way to proceed is to go and invest there. Fourth, the development of telecommunications through the Internet has allowed industrialized countries' firms to relocate some of their value creation activities to developing countries where they can find skilled manpower at favourable costs. Examples of this kind of FDI are back-office[57] accounting operations, call centres and software development and testing facilities.

3.1.2 Drivers of FDI and the joint venture option

Locational aspects

Nowadays, governments of developing countries compete heavily among themselves to attract foreign investors who have therefore substantial flexibility both in their locational strategies and their ownership strategies. The investment decisions of foreign companies

[57] *See* Glossary.

willing to set up operations in developing countries are influenced and shaped by various factors and motives, among which are:

The mobility of capital

Capital has a great mobility, while other production factors such as labour or natural resources are immobile or have a much lower degree of mobility; consequently, wherever there is an opportunity to achieve a competitive advantage through investment in a foreign country, capital will get there, and it will be easy to close operations in one country and move into another where factor conditions[58] are more attractive.

Access to natural resources

This was perhaps the main reason for the earlier stages of multinational expansion overseas in the nineteenth century, throughout the twentieth century and into the twenty first century. The aim of MNEs was to secure access to the natural resources, for example minerals, cotton, and petroleum, needed to supply their manufacturing activities. It is also the current practice of MNEs to consider that, if their product requires raw materials or other important inputs only available in certain countries, it may be advantageous to set up the production facilities close to these sources.

Access to markets

This is an important motivation for foreign investors, not only to be more competitive in the host country and exploit its market potential but also to export to neighbouring countries, or to countries that have preferential trade agreements with the host country. For example, a foreign investor setting up manufacturing operations in Mexico may be

FDI motives

Cell According to Dunning four main motives can be identified that prompt firms to undertake FDI (Dunning, 1993):

- *Market seeking FDI*—driven by location factors and the relevant dynamics and size of the market;
- *Natural-resource seeking FDI*—driven by the availability of natural resources;
- *Efficiency-seeking FDI*—driven by the search for efficiency through cost-saving and maintenance of competitiveness;
- *Asset-seeking FDI*—driven by the enlargement of the existing assets through JVs or acquisitions in order to sustain a competitive position.

Other categories or subcategories can be added to the above, such as labour-intensive FDI (Aaron, 1999); capital-intensive FDI; FDI with a high local manufacturing value-added; "Zone" FDI; service sector FDI; infra-structure FDI; mergers and acquisitions; joint ventures; wholly owned subsidiaries, etc.

[58] *See* Glossary.

thinking beyond the Mexican market to the easier access that it will now have to the United States and Canada, as provided under the terms of the North American Free Trade Agreement (NAFTA).

Access to low-cost labour

Gaining cost advantages through the use of the low-cost labour available in the host country is another important factor that drives investors to foreign locations. This may become a survival imperative when products and markets mature, the manufacturing processes become standardized, and new entrants put downward pressure on prices and profit margins, in which cases firms will seek locations where labour costs are lower and other production inputs are cheaper.

Access to knowledge

Foreign direct investment may be driven by the firm's interest in accessing specialized knowledge in order to improve their competitive position. This can be achieved through the acquisition of other firms in foreign countries for the skills they possess, or through setting up operations in locations where the desired technical capabilities can be found, for example Milan for the footwear industry, or Silicon Valley for the semiconductor industry, or Bangalore for the software industry.

Ownership aspects

Foreign direct investment can be regarded as a means of international business expansion and as one of the various possible alternatives through which firms can exploit competitive advantages abroad.

A question to be asked here is why a firm decides to assume the costs and risks of investing in a foreign country instead of exploiting these factor advantages through non-equity arrangements such as licensing agreements. And when they have decided to invest, why do they choose the option of a joint venture instead of a wholly-owned affiliate, which can be acquired through a greenfield investment or the acquisition of a foreign enterprise?

Licensing arrangements. This is the simplest and cheapest way for a firm to produce abroad since the licensee assumes the costs and risks of opening the foreign market. Furthermore, in the past, licensing has been the best possible solution for firms willing to exploit a foreign market but facing barriers to direct investment. However, licensing has limitations and drawbacks. One is that the control of the manufacturing operations, the marketing of the licensed products, and the related development strategies are in the licensee's hands and cannot easily be controlled by the licensor. Another is that technological know-how is the basis of the firm's competitive advantage and by licensing it to a foreign party the licensor may lose control of it and run the risk of creating a competitor.

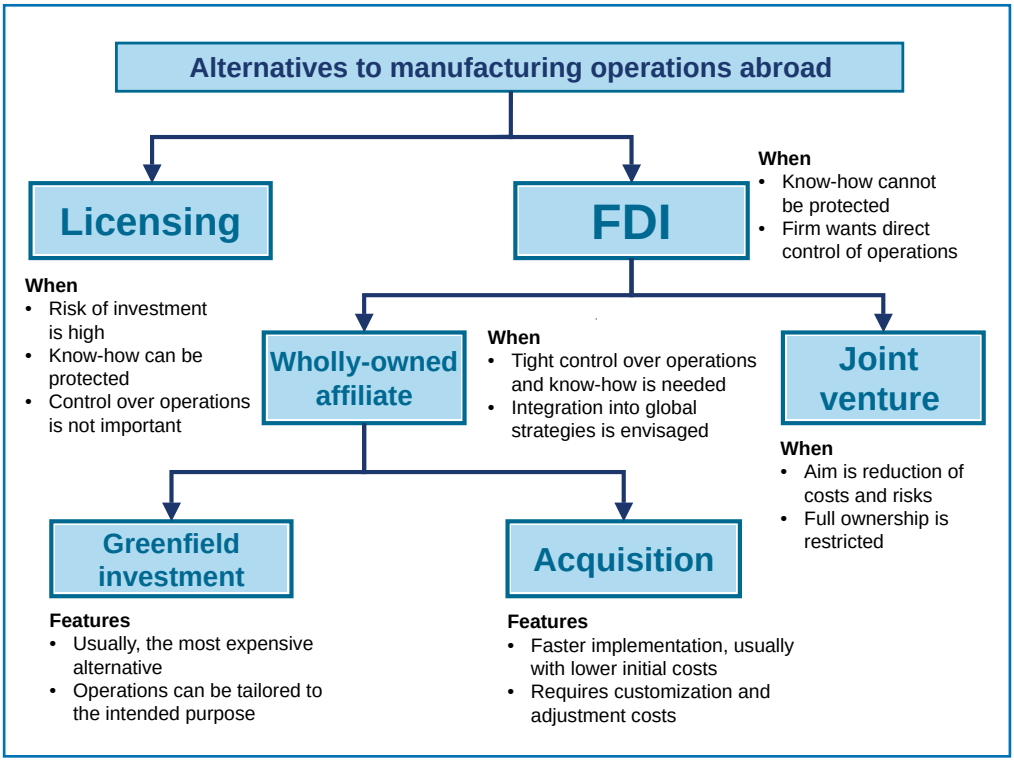
Wholly-owned subsidiaries. There are two ways for a firm to establish a wholly-owned subsidiary in a foreign country. One is to set up a new operation in the host country from grass roots, also referred to as a greenfield investment, and the other one is to acquire

an already existing firm in the host country and use it to manufacture the products or promote the services envisaged. For the investing firm, the advantages of establishing a wholly-owned subsidiary are:

(a) the firm can keep tight control of its technology and management know-how, which is particularly important when these assets are at the heart of its competitive advantage;
(b) through a wholly-owned subsidiary, the firm can more easily integrate the subsidiary's operations into a coordinated global strategy; and
(c) a wholly-owned subsidiary provides the best way to learn about the host country environment and its potential for upgrading and expanding operations in the future.

There are, however, disadvantages in opting for wholly-owned subsidiaries. The investing firm has to bear the costs and risks of setting up operations in a foreign country and face the unknowns, uncertainties and problems associated to the host country's culture, business environment and institutional setting.

Figure 3.1 Ownership options in operations abroad



The joint venture option. In a joint venture, the foreign investor and a local partner establish a jointly owned firm to conduct the intended operations in the host country. Through this option, the foreign investor reduces the costs and risks of opening a foreign market since it benefits from the local partner's knowledge about the host country—its language and culture, business patterns and operators, the characteristics of its labour market, its laws and regulations, and its political system. Besides, the existence of a local-equity partner makes the joint venture less vulnerable to hostile actions that may arise in situations of social or political instability.

For the foreign investor, however, joint ventures may present several drawbacks compared to having full ownership of operations. One potential problem is the possible loss of control of proprietary technology and know-how to the local partner. This risk can be minimized through a majority ownership in the joint venture, which allows for a greater control of the joint venture's operations, or through avoiding the sharing of state-of-the-art technology; but the risk is not to be underestimated, in particular in the event that the joint venture is terminated.

Another possible shortcoming of the joint venture option for the foreign firm is that it may not be easy to integrate the joint venture's operations into the firm's competitive strategies at global level; this might require sacrificing profit or operating at a loss. After all, joint ventures, even with foreign majority ownership, are separate legal companies with their own management and, possibly, a significant degree of autonomy.

Problems may also arise if the partners have different strategic interests—if, for example, the foreign investor is pursuing long-term objectives to the detriment of short-term profit while the local partner expects quick returns on the invested assets; or shifts in the balance of power between the partners may lead to conflicts over the joint venture's strategies and goals.

Review of chapter 3.1

Joint ventures in developing countries: a conduit of foreign direct investment

The success of joint ventures in developing countries depends on a convergence of interests that involve three parties, namely the foreign investor, the domestic company and the host government. Joint ventures are usually established as long-term agreements that remain in force as long as the business is viable and profitable.

Since the 1980s, the attitudes of developing countries to foreign direct investment have changed substantially. As a result of several factors and development trends, their previous restrictive positions gave way to increasingly liberalized policies.

Traditional foreign investors used to be large multinational enterprises from industrialized countries. Nowadays we are witnessing the emergence of new players and also a shift in the sector composition of FDI.

Private equity firms are playing an important role as investors, not only in industrialized countries but also in developing countries and emerging economies where they can be an effective vehicle for the upgrading and internationalization of local companies.

While extracting industries and manufacturing activities dominated the earlier forms of foreign direct investment, in the past two decades there has been a significant shift towards the services sectors, reflecting a general trend in industrialized countries.

Nowadays, governments of developing countries compete heavily among themselves to attract foreign investors, who have therefore substantial flexibility both in their locational strategies and their ownership strategies.

Among the motives for FDI we can count access to natural resources, access to markets, access to low-cost labour, and access to knowledge. Additionally, the mobility of capital gives investors considerable locational flexibility and encourages FDI flows.

FDI through wholly-owned subsidiaries or joint ventures appears to be a means of international business expansion and can be regarded as one among the various possible alternatives through which firms can exploit competitive advantages abroad.

With the joint venture option, the foreign investor reduces the costs and risks of opening a foreign market since it benefits from the local partner's knowledge of the host country, its language and culture, its business patterns and operators, the characteristics of its labour market, its laws and regulations, and its political system.

3.2 The joint venture as a framework for cooperation and development

3.2.1 Possible departures and motives

As joint ventures may require substantial investments, involve long-term commitments, and entail considerable risks, their formation has to be preceded by a careful and time-consuming preparation. Through the proper analytical work, including opportunity studies and feasibility assessment, the parties should have a clear perception of the project profitability; equally important is that they have achieved a high degree of confidence with each other, which is an indispensable foundation for an enduring and mutually beneficial relationship.

The process leading to a joint venture between a foreign investor and a domestic company in a developing country can start in different ways:

The initiative can come from a local company ...

... that has a good project idea for expanding its ongoing business, or introducing a new and improved range of products, or aiming at developing export-oriented capabilities, or that simply needs to modernize its manufacturing operations in order to overcome the threats of competitors,

... but does not have the technology, the innovative capabilities, the managerial skills, nor the knowledge of foreign markets, and even lacks the financial resources to implement the project.

The local company therefore needs a foreign partner able and willing to provide the necessary resources.

The initiative can come from a foreign company ...

... that wants to set up manufacturing operations in the developing country, either to sell its products in the local market or to benefit from locational advantages, for example in low-cost labour, available raw materials, or favourable geography, and aims at exporting,

... but cannot establish a wholly-owned subsidiary because of restrictions imposed by the host country legislation, or does not want to do so because of perceived risks associated to foreign investment in the host country.

The foreign company therefore looks for a local company suited to becoming a partner in a joint venture.

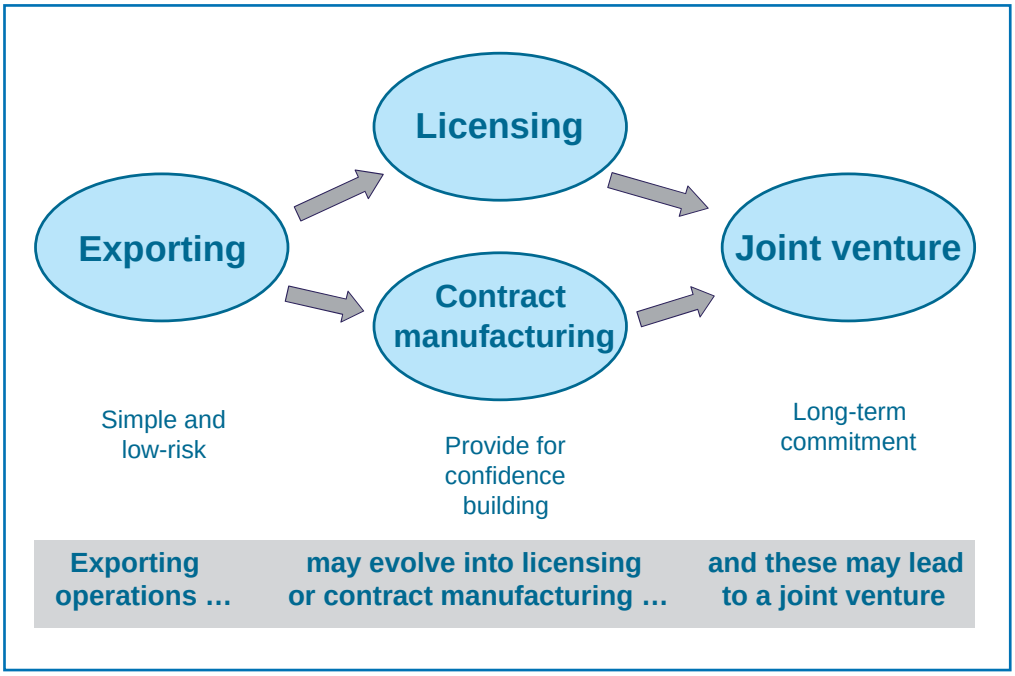
The joint venture can derive from existing alliances ...

... when, in the process of internationalization, firms prefer to move stepwise in order to minimize risk and allow for learning about the targeted markets before getting into a higher level of commitment and risk,

... in which case firms can start with exporting activities, which appear to be the simplest and least risky way to enter a foreign market, then go into licensing or contract manufacturing, with a domestic firm as a partner, and then move towards a joint venture when they have gained experience and knowledge about the host country, trust between partners has been established, and the market potential justifies the risk of investment in a long-term perspective (figure 3.2).

The decision for a joint venture may result from previous cooperation and trust established between the parties.

Figure 3.2 Possible path to a joint venture



3.2.2 The partners' inputs

Irrespective of who takes the initiative to start the process, the formation of a joint venture requires a package of inputs to achieve the envisaged objectives. These inputs, both tangible and intangible, which the partners altogether have to make available, could be:

- capital and land;
- buildings and equipment;
- technical know-how;

- licences (patents, trademarks);
- manufacturing skills;
- marketing experience;
- managerial competence;
- training of local staff.

In the formation of typical joint ventures in developing countries, i.e. those involving a foreign investor and a domestic company, the inputs expected from each of the partners can be represented as indicated below and illustrated in table 3.3.

Foreign partner's inputs

The foreign company is expected to be:

- a manufacturer of leading products with advanced innovative capabilities;
- well established in the market and with a good international distribution network;
- willing to expand and set up operations overseas and to improve competitiveness and profit through the various locational advantages found in the host country.

In addition to these, the main contributions expected from the foreign partner to the establishment of the joint venture will, in principle, be the supply of technology, including know-how, patents, copyrights, trademarks and equipments, new managerial techniques, training of personnel and, possibly, financial resources.

The foreign partner may also supervise the design of the plant to be operated by the joint venture company, or supply the various services and inputs needed to set up the plant; but it is also common that the engineering, equipment procurement, installation of machinery, and construction and start-up of the plant will be carried out by an unrelated contractor selected through a public tender procedure.

Table 3.2 What partners expect from each other

Joint ventures: partners' expectations

Domestic partner	Foreign investor
• Acquisition of technology	• Market expansion and added profits
• Introduction of new products	• Access to raw materials
• Access to improvements	• Decrease exposure and risk
• Increased productivity	• Easier contacts with government
• New management techniques	• Smoother relations with workforce
• Access to new markets	• Use local managerial and professional talent
• Training of personnel	

Local partner's inputs

The domestic company is expected:

- to be well established in the host country, with proven experience in manufacturing and marketing activities in the domestic market;
- to have good connections to the domestic industrial and trading companies, and solid knowledge of the institutional and regulatory mechanisms;
- to be seeking opportunities to upgrade, expand or diversify its business, not only in the domestic market but possibly also by becoming an exporter;
- to have capacity to establish and implement contacts with potential foreign partners and to be able to implement the negotiation process leading to the formation of a joint venture.

All the above are important features that can be regarded as intangible inputs that will result in easier contacts with the government, more effective links with domestic suppliers and customers, smoother relations with the local workforce and, ultimately, decreased exposure and political risk for the foreign investor.

The local partner can also contribute to the joint venture with such tangible measurable inputs as land, buildings, manufacturing infrastructure and, possibly, capital.

3.2.3 Benefits for host country; role of governments and other players

Possible benefits of FDI and joint ventures ...

Even in the most liberalized regimes, where business initiatives and partnerships rest on the unconstrained willingness of private parties, governments also have interests at stake and an important role to play in the implementation of joint ventures.

This is because joint ventures, as a form of foreign direct investment, may bring important benefits to the host country and have an impact on its economic development and growth. This can be represented in general terms as follows:

- access to new technological know-how as well as to modern equipments and production facilities, with a corresponding positive effect on the host country's modernization;
- spillover effects into the host country's business environment through linkages with local suppliers of goods and services, which result in a learning and upgrading process;
- increased export potential, not only for the joint venture's products but also for the goods manufactured by their domestic suppliers, which improves the balance of payments;
- development of domestic entrepreneurial skills and managerial capabilities which are needed to implement effective strategies for competitiveness, growth and internationalization;

- improved growth of the domestic economy, through its overall contribution, with positive effects on various aspects of human development, as in job creation, education, gender equality, improved heath, etc.

... but enabling conditions are needed ...

The potential benefits of FDI and, more so, the benefits of joint ventures seem unquestionable. The problem for developing countries is to attract foreign investors and make them set up and maintain their operations in the country with a long-term perspective instead of just taking advantage of short-term cost benefits of some sort and then moving on to another location that might become more competitive.

There are conditions which are necessary, even though not sufficient, to create an enabling host environment to capture FDI. Such conditions give foreign investors the sense of security and predictability they need to be confident that their operations abroad can be smoothly set up and expanded, their ownership of their proprietary rights respected and their profits timely repatriated. They are:

- political stability, including the good governance, accountability and transparency of public sector institutions;
- economic stability, i.e. economic strength through the fabric of inter-transactions, intermediation and subcontracting;
- an international outlook, global in thinking and behaviour, on the best practice and policy framework;
- government regulations, with clear and comprehensive codes for investment and including a framework for the protection of foreign investments, intellectual property rights and the repatriation of profits;
- infrastructure, such as transport and communications facilities, and distribution logistics, efficiencies and operabilities;
- banking and financing mechanisms, including concessionary credit for investment activities, export guarantee schemes and strong intermediation capabilities and capacities;
- government attitude, i.e. service orientation and local business infrastructure with possible backward and forward linkages;
- quality of life and, in particular, personal safety, efficient health care and a good education system.

... as well as mechanisms to support local companies

Foreign investors moving into a new market usually need local firms as suppliers of maintenance services or as suppliers of materials, components and other required inputs. Through the linkages so established, these firms can be upgraded to encompass more demanding tasks, involving more added-value, which results from a learning effect on the local firms and a process of knowledge accumulation with a consequent leveraging of the technological capabilities of the host country. And the deeper the relationships with

domestic firms, the more the foreign investors will be motivated to keep their operations in the country on a long-term perspective. However, the technology transfer element of FDI can only start and be implemented if there are domestic firms with a sufficient level of competence to become suppliers of goods and services to the foreign investors.

In order to move up the technology ladder through linkages with foreign companies, the domestic firms, as a rule SMEs, basically need the convergence of two kinds of requisites:

First, their own technological effort, which means the willingness to undertake a conscious, purposeful and consistent endeavour to learn, innovate and improve, and, ultimately, internationalize.

Second, the support that can come from government and other players, without which the domestic firms of developing countries might not be able to succeed in the path to internationalization.

As highlighted in part 1, section 1.3.3, the success stories of technological progress witnessed in a number of East Asian countries have a lot to do with the support provided by governments to their domestic firms, namely to their SMEs. One form of government support is the implementation of policies and the creation of conditions that stimulate entrepreneurial dynamism and encourage investment both by domestic firms and by foreign investors.

Governments can also play an essential supporting role through specialized institutions in such areas and functions as:

- monitoring developments and trends in the global economy, identifying the opportunities and priorities for national enterprises, and helping to build-up linkages between the national innovation system[59] and the country's SMEs;
- promoting inflows of foreign direct investment, while keeping in mind the country's development interests and priorities, and encouraging linkages between domestic suppliers of goods and services and the foreign firms established in the country;
- assisting in the internationalization of national SMEs by providing them with relevant information on foreign markets that are of potential interest to them, and also with business intelligence that will facilitate their participation in the supply chains of multinational enterprises.

At the national level, the main players are organizations like investment promotion agencies (IPAs) which, in addition to being regulatory bodies issuing licences for foreign investment operations, should increasingly become facilitating agents working in close cooperation with the other main stakeholders in investment promotion. These include the private sector as well as the government departments dealing with various aspects of investment (taxes, customs, land, visas, permits, etc.) and infrastructure-related entities (power, transportation, standards and quality bureaus and laboratories, technology institutes, export promotion bodies, etc.).

[59] *See* Glossary.

At the international level, what primarily comes to mind is the role of foreign direct investment through the multinational enterprises that set up manufacturing operations or service industries in the country. But there are also meaningful players that should not be overlooked, such as equity funds and investment banks.

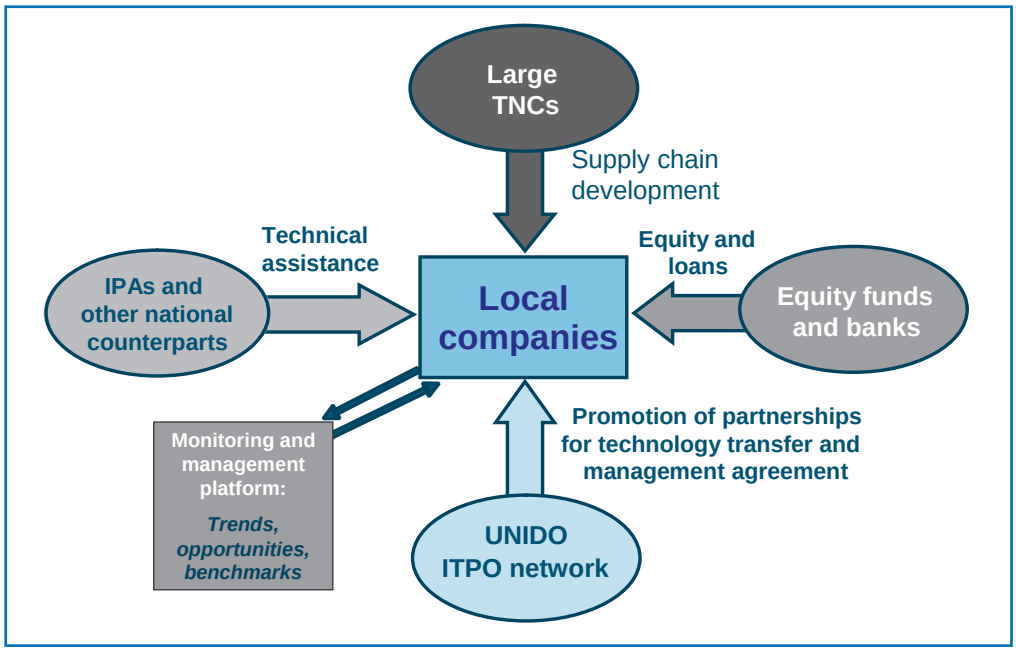
Equity funds have a natural vocation to upgrade the firms in which they take equity or to which they provide loans, and this means, as we have seen in section 3.1.1, all the advice and assistance that it is needed to develop and implement successful growth strategies.

By the same token, investment banks and other concerned financing institutions may also play a meaningful supporting role for the enterprises that use their lending services.

International organizations are another relevant source of international support, which may become essential in cases where the national institutional infrastructure is ineffective or does not exist. UNIDO, for example, provides developing countries with an extensive range of supporting services as well as proprietary training packages and tools. It brings together critical stakeholders like banks, private consultants, chambers of commerce, manufacturers and other professional associations as well as the IPAs, ministries and parastatals, through a core group made up of their representatives. The core group is established to jointly assess companies and develop a picture of "state-of-enterprise" in target subsectors. The extensive training in the application of UNIDO tools provides the members of the core group with common appraisal standards and analysis methodologies that facilitate closer cooperation in project development and financing. The specific outputs are subsector profiles based on company data and comparative analysis of competitiveness with competing countries. The company profiles are also used by IPAs for promotion through the UNIDO Investment and Technology Promotion Offices (ITPOs).

Figure 3.3 displays the many players and mechanisms that support FDI-SME development.

Figure 3.3 Mechanisms to support FDI-SME development



Review of chapter 3.2

The joint venture as a framework for cooperation and development

The process leading to a joint venture between a foreign investor and a domestic company of a developing country can result from diverse motivations and start in different ways. In all cases, a high degree of trust between the partners is indispensable as a foundation for an enduring and mutually beneficial relationship.

The initiative can come from a local company, willing to upgrade its business or acquire new capabilities and needing a foreign partner with the capability and willingness to provide the needed resources, for example technology, managerial skills and knowledge of foreign markets.

The initiative can come from a foreign company that wants to set up operations in a particular country, either to sell its products in the local market or to benefit from locational advantages, and looks for a suitable local company to become its partner in a joint venture.

The joint venture can derive from existing business relationships, for example exporting operations, licensing, or contract manufacturing, through which the partners have built up confidence to move to a higher level of commitment.

Irrespective of who takes the initiative to start the process, the formation of a joint venture requires a package of inputs to achieve the envisaged objectives.

The main contributions expected from the foreign partner to the establishment of the joint venture will, in principle, be in the supply of technology, new managerial techniques, training of personnel, market experience and, possibly, financial resources.

The local partner can ensure easier contacts with the government, more effective links with domestic suppliers and customers, and smoother relations with the local workforce, and can also contribute tangible, measurable inputs like land, buildings, manufacturing infrastructure and, possibly, capital.

Governments also have interests at stake and an important role to play in the implementation of joint ventures because, as a form of foreign direct investment, they may bring important benefits to the host country and impact on its economic development and growth.

There are conditions which are necessary even though not sufficient to create an enabling host environment to capture FDI. Such conditions give foreign investors the sense of security and predictability they need to be confident that their operations abroad can be smoothly set up and expanded, the ownership of their proprietary rights respected and their profits timely repatriated.

The technology transfer element of FDI can only start and be implemented if there are domestic firms with a sufficient level of competence to become suppliers of goods and services to the foreign investors.

In order to move up the technology ladder through linkages with foreign companies, the domestic firms, as a rule SMEs, basically need the convergence of two kinds of requisites: first, their own technological effort; and, second, the support and that can come from government and other players.

3.3 Development of a joint venture relationship

The successful implementation of a joint venture involves a relatively long process, sometimes stretching over several months or even years. It requires a methodical, patient and persevering approach where every precaution should be taken to minimize the risks of failure. The partners should keep in mind that a joint venture is a long-term commitment involving substantial investments in terms of financial resources and management time, and should therefore be implemented stepwise, proceeding further as confidence builds up, and even dropped if, at a certain stage, it is found that conditions do not meet the partners' expectations in a way that satisfies both of them. Better to recognise the mismatch at an earlier stage than end in acrimony, with a sense that substantial resources have been committed and wasted, and expectations raised and then frustrated.

In some cases, the joint venture is a natural extension of previous business relationships established between the partners, for example through trade-related activities or licensing agreements. In such cases a joint venture is the end result of a successful relationship in which the parties have jointly come to the conclusion that, by joining their forces and their knowledge, they could inject a new dimension into their relationship. In other situations, the foreign company has objectives of its own in the host country and needs to find a particular local partner; or a local company wishes to upgrade its operations or set up a new activity and looks for a foreign partner able to supply the required technology and other inputs.

What follows is a general representation of the process that such companies can follow, up to the establishment of a joint venture. To some extent, the process is presented from the perspective of the host country firm; but the general principles and steps listed below also fit the foreign investor's requirements, mutatis mutandis. Besides, beyond a certain stage, the activities leading to the joint venture are undertaken jointly.

3.3.1 From the early stage ...

Management decision; strategy and objectives

The process starts with a management decision on the strategy and objectives that call for the new project and may lead to the joint venture. It may happen that, when initiating the process, the company is thinking of other alternatives, for example realizing the project trough a licensing agreement. The joint venture option may emerge as a result of the exploratory discussions with potential partners.

Triggers for the management decision may differ from case to case. It could be that the investment climate in the country is favourable and there are incentives for entrepreneurial initiatives; or there is a good market opportunity for the envisaged goods or services; or there is a perceived competitive threat and, as a matter of survival, the firm needs to respond through modernization and improved products.

Opportunity study and project profile

The management decision to consider the new project has to be accompanied by an opportunity study,[60] which analyses various project-related parameters and requisites and gives a preliminary indication that there are sufficient conditions to take further steps, for example start searching for suitable sources of technology, or undertake a more in-depth market assessment and collect data and cost estimates of the financial, technical and staffing requirements. All this data can be integrated into a project profile, which can be used as an instrument to advertise the project and for exploratory contacts with potential partners.

The joint venture at the early stage

Management decision: Triggers for decision may differ from case to case, e.g. investment climate, market opportunities or competitive threats.

Opportunity study: Gives preliminary indications of the conditions to take further steps and allows for the preparation of a project profile.

Pre-feasibility study: Intermediary step to examine basic questions of possible future joint venture and decide on whether to proceed with more thorough studies, including a full-fledged feasibility study.

The next steps would involve collecting and reviewing additional relevant project data and applying the usual methods and techniques of evaluating such data in order to arrive at the pre-feasibility study.[61]

Pre-feasibility study as intermediary step

The final investment decision requires a detailed techno-economic study called a feasibility study,[62] which will take into account all the relevant factors and elements for the creation and operation of the joint venture. The feasibility study is a costly and time-consuming undertaking. Consequently, prior to allocating funds to such a study, a preliminary assessment is usually made in the form of a pre-feasibility study, which examines only certain basic questions about a possible future joint venture.

If such a pre-feasibility study shows that the project is neither a viable proposition nor attractive for a potential investor, then the process will stop, without having to incur the costs of a full-fledged feasibility study.

If the pre-feasibility study gives positive results, the parties may decide to continue with their contacts and proceed with more thorough studies.

[60] *See* Glossary.
[61] *See* Glossary.
[62] *See* Glossary.

3.3.2 ... through the pre-negotiation stage ...

Pre-negotiation stage (Phase I: getting acquainted)

At the time of elaborating the pre-feasibility study, the company is supposed to have made the search for potential partners, undertaken exploratory contacts and, among possible options, targeted the one appearing most suited to doing business with.

At the beginning, while still at the "getting acquainted" stage, it is already important to know "what one wants" or what one will eventually be negotiating about. At this stage, whatever project information has been identified should have been collected, organized and analyzed to enable the proponent to present a convincing project proposal to a potential partner.

It also seems appropriate to discuss transfer costs at the first meeting as it may be necessary to obtain at least indicative figures to complete the pre-feasibility study. The first meeting also serves to break the ice and establish common ground.

Pre-negotiation stage (Phase II: due diligence)

This stage is characterized by an in-depth analysis of the proposal and an identification of additional information needed by the potential partner, who will consider the pros and cons of entering a business relationship with the other side and whether there is a strong motivation for doing so. A special team might be formed by each side to pursue this analysis and evaluation more systematically. Independent sources can also be tapped for any additional information that might be needed. Such an analysis, which, in business practice, is called due diligence,[63] would focus on the nature and suitability of the proposed technology and its costs and payment modality, and would extend to cover the potential partner's personality, cultural fit and management practices as well as the firm's commercial standing. This is the time when changes can still be introduced to take advantage of a full range of alternatives and options, which in turn may suggest the fine-tuning or the re-directing of the pre-feasibility study.

Pre-negotiation stage (Phase III: letter of intent)

During this phase the relationship between the two firms begins to take on form. There might be different options on the type of collaboration best suited for the envisaged purpose. It could be, for example, a contract to transfer the desired technology, a management contract, a marketing agreement, a technical assistance and training agreement or, of course, a joint venture, as in the case under consideration. This is a threshold decision and, after it has been taken, the room for changing the scope and/or nature of the project will be reduced. Contacts between the potential partners are now intensifying and this can include exchange of letters, personal contacts and discussions, and plant visits. Exchange of proposals and counter proposals is now substantiated by the results of completed studies, such as the pre-feasibility study and other supporting studies that might be needed.

[63] *See* Glossary.

The joint venture at the pre-negotiation stage

Phase I: getting acquainted. Exploratory contacts to collect information, consider possible options and obtain indicative figures.

Phase II: due diligence. Analysis of the project proposal, the suitability of the technology, and the partner's credentials and standing.

Phase III: letter of intent. Whether binding or not, the letter of intent represents a threshold decision in the partner's engagement.

Phase IV: preparing for negotiation. This comes when some basic aspects have been settled but others need fine-tuning for final negotiation.

This phase could be considered the engagement period, symbolized by the signing of a letter of intent (*see also* section 3.4.4).

Pre-negotiation stage (Phase IV: preparing for negotiation)

Early in this phase, the decisions about the form of relationship and other vital aspects have usually been taken since these constitute essential inputs to the feasibility study which is now in progress. In previous contacts with each other, either through visiting executives or the available communication channels, certain issues may already have been agreed upon, such as the financial structure, ownership, management and technical assistance, while others are now under consideration and in final preparation for the forthcoming negotiations. A fine tuning of parameters, preliminary arrangements with financial institutions and, finally, the scheduling of the actual negotiation sessions conclude what is commonly called the pre-negotiation stage.

3.3.3 ... to the negotiation process

Negotiations for the establishment of a joint venture usually take a long time because there are many issues which have to be solved before an agreement can be signed. A joint venture agreement is usually a long document, often consisting of several separate but interrelated contracts, which cover in detail all aspects of the future relations of the partners within the joint venture.

Although all joint venture agreements are similar in their basic legal structure because all of them cover the same kind of issues, it is not easy to establish a model form for such agreements like those for other types of agreements in international trade transactions. The reason for this is that every joint venture involves many unique issues, some of which are intrinsic to the motivations and interests of the parties and are settled through the negotiation process while others depend on specific requirements of the national legislation where the joint venture will be incorporated.

It is advisable that, while the feasibility study is being carried out, each of the partners establishes a negotiation team with the specific purpose of preparing and conducting the

In order to provide some clarity on the breadth and intricacies of the subject of joint venture agreements, we present the agreement in the form of various interrelated elements, namely:

(a) the negotiation steps;

(b) selected issues for joint venture negotiators;

(c) the structure of joint venture agreements.

As an add-on to these elements, which are specific to the process of implementing joint ventures, we present two supplementary chapters in part 4, one dealing with the general principles of international business negotiations and the other devoted to contracts and contract drafting.

formal negotiations. The team's first task may consist of delineating what has already been agreed upon by the two parties during this pre-negotiation phase and what is still open for negotiation. The negotiations should, in principle, start as soon as the feasibility study is completed and shows positive results.

A proposal should be prepared by the local company (we are supposing the local company is the project proponent) and submitted to the other party, who would be officially invited to become a joint venture partner. The proposal should also touch upon the main aspects considered relevant by the proponent, such as:

- the share of ownership intended to be assigned to the partner, whether 50 per cent or some other amount of equity holding as may be required by the host country law;
- what is expected in terms of the supply of technology, intellectual property rights, access to and ownership of improvements, training of staff, costs and modality of payments, etc.;
- envisaged membership on the board of directors and management of the joint venture, which would be commensurate with the equity ownership of the partners;
- views on the specifications as well as on the marketing and sales of the products and on the principles underlying business transactions likely to occur between the joint venture and the partners;
- indication that the local company will be responsible for the registration of the joint venture company and all other necessary dealings with the government (this is the rule, but the foreign company can also do it through representatives eventually established in the host country).

The foreign company's team, in turn, while waiting for the feasibility study to be completed, may have drafted a number of preliminary documents for the domestic company's consideration. These documents respond to the proposal received, either confirming concurrence to the various specific items put forward by the domestic company or leaving other items open to the onward negotiation.

As a result of the above mentioned exchanges, a substantial common ground will have been achieved but there are still many issues and details left open to negotiation, as we shall see.

In a typical manufacturing joint venture, the documents to be submitted by the foreign company are expected to cover the following areas:

- the supply of technology in its various components, i.e. patents, know-how, machinery, trademarks (eventually), training, etc., including information on prices and payment modalities;
- the intended or desired equity participation, often in terms of machinery and equipment supply, whose value should be on the basis of sound business practices;
- the number of board members and the management structure, also having in mind that this kind of decision has to abide by the foreign investment codes and corporate laws in place;
- eventual provision by the foreign company of bank guarantees necessary for medium term loans and of technical assistance as may be required to satisfy financial institutions regarding the technical feasibility of the project.

Upon completion of the feasibility study and confirmation of the pre-feasibility study's positive findings, it is time to submit an application to a financial institution, for example a development bank, for the loan that will be eventually needed and to make a thorough review of the proposals exchanged and enter the phase of preparation for the actual negotiations by focusing on key issues still open, which can be listed in an "agenda of issues to be discussed and cleared".

Selection of the negotiation team

Chapter 4.1, on international business negotiations, elaborates on the issues related to the establishment of a negotiation team and the guiding principles related to the selection of the team members, including the composition of the team, articulation among the members, the role of the team leader, and so on. At this stage, we would simply highlight the fact that the negotiation team is usually established from the group of experts which carried out the preparatory work. They are selected because they are familiar with their counterparts and know not only the strengths and weaknesses of the proposed project but also the characteristics of individuals on the other side.

Choice of negotiation venue and time

If the local party is the host of the new venture, it will normally be the one to decide on the location and time for the negotiations. Experience shows that it is best to meet at one's own or at a neutral location. Meeting at home allows the negotiation team to control the situation more easily. If one's own office is chosen, it gives the advantage of immediate access to all means of communication and background information. It is always advantageous to be able to immediately check statements regarding the facts of issues in question. Meeting at a more neutral place, such as a hotel, may also have advantages as it creates an atmosphere of ease that is favorable to discussion and avoids distractions.

Final preparations for negotiation

The final preparations for the actual negotiation sessions begin with the establishment of a structured checklist of issues which will ultimately be reflected in a clause or clauses of the joint venture agreements and ancillary agreements, and represent the substance of the joint venture company.

An example of the main headings of such a checklist could be as follows (*see also* section 3.3.9 and chapter 3.4):

(1) Formation of the joint venture company;
(2) Objectives of the company;
(3) Composition of ownership and capital structure;
(4) The rights to select directors;
(5) The management of the joint venture company;
(6) The rights of shareholders in general;
(7) Incentives to be gained from the government;
(8) Marketing arrangements;
(9) Financial policies;
(10) Duration and termination of the company;
(11) Change of the partnership arrangement;
(12) Settlement of disputes;
(13) Remaining issues;
  (a) The foreign patent licence agreement;
  (b) The foreign know-how licence agreement.

Some of the key issues listed above must have been, at least in part, the subject of extended discussions between the two sides, if not already agreed upon at this stage. Others remain open for negotiation, and it is these that will now require analysis and intensive preparation by both negotiation teams. In the actual negotiation agenda, the parties may decide to discuss the issues in a sequence that is different from the one shown in the above list.

The agenda

It is general practice to establish a preliminary agenda ahead of time, listing the issues to be negotiated and also including other relevant information about the forthcoming meeting. The sequence of agenda items and their contents usually remain open until the negotiations start as this is usually the first item to settle. It may be decided to open the agenda with a review of the overall objectives of the future joint venture in order to reach a full understanding of the more fundamental issues at the very beginning. Next in line could be the formation of the company, i.e. its name, legal setting, etc., which might have already been more or less cleared in previous discussions, but could still require final agreement.

Review of chapter 3.3

Development of a joint venture relationship

A joint venture is a long-term commitment involving substantial investments in terms of financial resources and management time. Its successful implementation is a relatively long process. It requires a methodical, patient and persevering approach where all precautions should be taken to minimize the risks of failure.

Triggers for the decision to implement a joint venture may differ from case to case. It could be that the investment climate in the country is favourable; or there is a good market opportunity; or there is a perceived competitive threat and the firm needs to respond through modernization and improved products.

The feasibility study is a costly and time consuming undertaking. Consequently, prior to allocating funds to such a study, a preliminary assessment is usually made in the form of a pre-feasibility study, which should examine only certain basic questions about a possible future joint venture.

The early stages of developing a joint venture relationship include:

(a) the management decision, including the definition of strategy and objectives;
(b) the opportunity study and the preparation of a project profile; and
(c) the pre-feasibility study.

The pre-negotiation stage comprises various phases, including:

(a) exploratory contacts for the potential partners to get acquainted with each other's motives;
(b) the due diligence process;
(c) the issuance of a letter of intent; and
(d) the preparation for negotiation.

Every joint venture involves many issues which are unique to it. Some of those issues are intrinsic to the motivations and interests of the parties; others depend on the specific requirements of national legislation where the joint venture will be incorporated.

The negotiation team, when formed, should delineate what has already been agreed upon by the two parties during this pre-negotiation phase and what is still open for negotiation, and the negotiations should, in principle, start as soon as the feasibility study is completed and shows positive results.

3.4 Selected issues for consideration

3.4.1 Joint ventures and host country laws

When planning for the establishment of a joint venture in a foreign country, the parties should pay attention to the national laws of the host country and consider how they may impact on the life of the joint venture company.

In general, the various areas of law such as contract law, administrative law, company law, taxation law, foreign exchange law and labour law should be taken into consideration. Inasmuch as a joint venture is a form of foreign direct investment, even international law can be brought into play.

Many countries have enacted specific legislation on foreign direct investment, which also contains provisions on the conditions under which a joint venture agreement may be concluded, administrative procedures for registration of such agreements, approvals by government organs that have to be obtained for such contracts to enter into force, the rights and duties of foreign investors and domestic partners, etc.

Attention to the host country laws

Since the joint venture is a new company, registered and established in the host country, many of its important features will have to be in conformity with the provisions of the local company law; for example, the internal management structure of the new company, the type of company, the position and rights of shareholders, the rights of managers, the operation of the company, and many other features will all be regulated by the relevant, applicable national laws.

Other provisions on joint venture agreements are concerned with such issues as capitalization and ownership, relations with the relevant authorities of the host country, the purchase of equipment, raw materials, components and other factors of production, foreign trade rights related to purchases and marketing, foreign currency regulations, basic rules of taxation, accounting and auditing, labor and personnel issues, the applicable law and the settlement of disputes, etc.

3.4.2 What can be invested; the valuation of inputs

Investments in a joint venture may be either in the form of tangibles (money, plant, machinery, raw materials, land, etc.) or intangibles (technology, technical information, marketing knowledge, management training, labour, etc.) (*see* table 3.3).

The problem of the contributions of tangible and intangible inputs is connected to their valuation. Such problems do not exist with contributions in monies or any such contributions which have an open market price. There are important disadvantages in cases of

unrealistic valuation of tangible or intangible investments. Inflated prices for whatever is being invested (technology or equipment) will distort the whole capital structure, including the debt to equity relationship. Furthermore, if the value of a particular input is artificially increased, the supplying partner will withdraw higher profits from the joint venture than he would be otherwise entitled to (to the detriment of the other partner), and he would additionally be entitled to withdraw the artificially high value at the end of the joint venture as his capital participation.

Table 3.3 Different kind of assets can be invested

What can be invested?

Tangibles	Intangibles
• Plant	• Technology
• Machinery	• Technical information
• Money	• Marketing knowledge
• Land	• Management training

Many national legislations allow investment of tangible and intangible property in joint ventures, and many have a requirement that the valuation has to be "realistic" and carried out according to acceptable rules.

However, whenever an investment is subject to valuation, the problem is how to value such an investment in a realistic manner.

Usually, national legislations allow investment of tangible and intangible property in joint ventures, and many have a requirement that the valuation has to be "realistic". Furthermore, regulatory bodies in charge of the evaluation and approval of joint venture applications have a concern about ensuring that the valuation of the partners' tangible and intangible contributions has been done on a reasonable and sound basis.

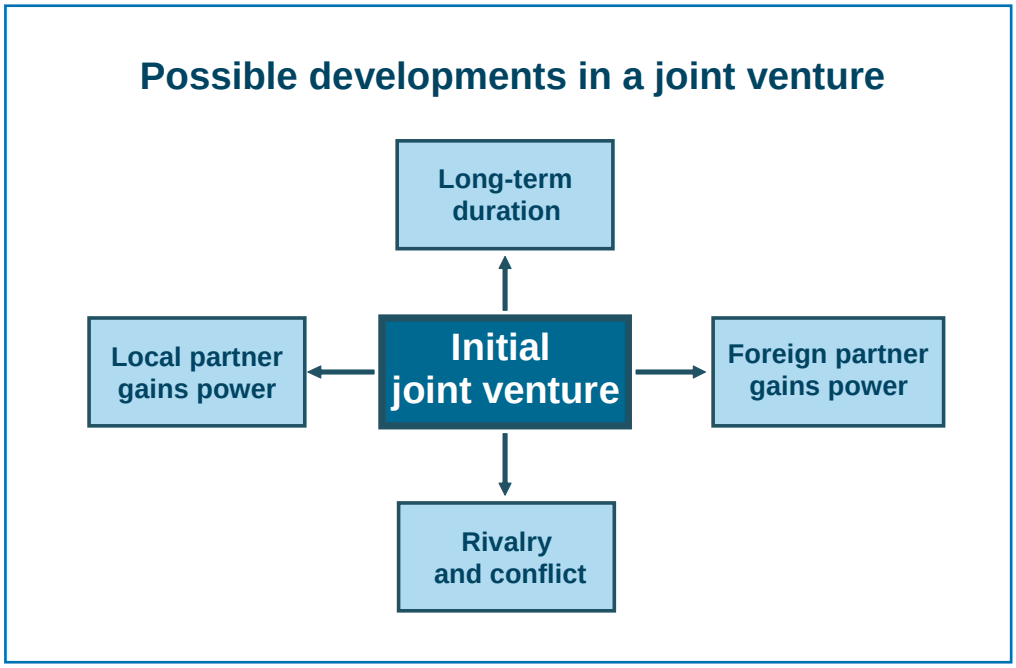
The concerned parties or the government supporting agencies may develop suitable evaluation procedures, which could be perfected with the analysis of the various components that integrate a particular investment input (unpackaging) in order to better understand and assign a value to each component or they could compare the proposed value with available data related to known arms-length transactions. The valuation can also be done by independent consultants.

3.4.3 The balance of power; keeping relevance as a partner

The foundation of a joint venture, projected to become a solid and durable undertaking, rests on the complementarity of the partners' contributions and the partners' recognition that they need each other and that none of them alone would be able to contribute all the required inputs.

But it is not only the actual contribution of resources a party makes to the joint venture that counts; it is also what the other party perceives that contribution to be and the value they place on it. A perception by one party that it is making an unequal contribution of resources can lead to the failure of some ventures.

Figure 3.4 The balance of power may change over time



Over time, their perceptions of the relative importance of each other's contribution, and whether the actual operation of the joint venture is fulfilling each partner's aspiration, can determine the stability of their relationship.

In terms of the balance of power, joint ventures may evolve along one of the four following paths, as illustrated in figure 3.4.

(a) *The joint venture becomes a long-term, successful relationship, as originally intended by the partners.* The joint venture between Xerox and Fuji Photo to form Fuji-Xerox (*see* part 1, section 2.2.1) was formed in 1962 and is still alive and well. Extensive surveys carried out by UNIDO in African countries have also shown considerable longevity and stability of joint ventures established between multinational enterprises and local companies.

(b) *The power balance shifts to the foreign partner, ending with a buyout or dissolution.* This may happen either because the relevance of the local partner's contribution weakens over time or the foreign partner has an assertive strategy to take control of the local market by promoting its own products and brands and by learning about the local business and institutional environment.

(c) *The power balance shifts to the local partner.* This situation also happens sometimes. The local partner may perceive that the contributions of the foreign party have become less important as it develops greater competence in production, technology, management, marketing, financial control and other areas. This could lead to the restructuring of the joint venture and increased ownership by the local partner.

(d) *Competition and rivalry between the partners.* It may happen that, in addition to sharing ownership and interests in the joint venture, the parent companies are rivals and compete with each other in other markets and eventually with the joint venture itself. This may naturally lead to a situation of conflict, which could result in the dissolution of the joint venture or its acquisition by one of the parties.

Staying relevant as a partner

Although developing country partners are currently perceived as the more vulnerable in shifts in the balance of power, they may nevertheless have or develop strengths that can be used to keep and eventually increase their relevance in the joint venture. This also requires a willing strategy to build power, a continuing assessment of strengths and weaknesses in the balance of power (e.g., over such determinants as technology, brand ownership, local relationships, etc.), and being pro-active to sustain and increase their strength.

Examples of sources of power that can be nurtured and strengthened by the developing country partners and may not easily be challenged by the foreign partner, at least in the short-term, are:

- overall knowledge of the domestic business environment and relations with government;
- ownership of local brands which can command recognition and consumer preference;
- control over distribution and technical and marketing assistance to dealers and customers;
- proprietary assets that allow the control of inputs that are needed by the joint venture.

3.4.4 Letter of intent and other preliminary agreements

Because the process leading to the negotiation and establishment of a joint venture is long and complex, it may be a good idea to draw up and sign some preliminary documents, designated as letters of intent, preliminary agreements, memoranda of understanding, protocols, etc. These are normally used to record the steps related to the project under negotiation which have been taken so far by the parties, and possibly also to record agreement on the measures still to be taken, as a way of facilitating further negotiations.

The following examples illustrate the intricacy of the subject.

Parties sometimes make a commitment to enter into a binding contract at a later time. In some legal systems (common law[64]) such "agreements to agree" or "contracts to make a contract" are, in general, not considered binding. In other jurisdictions (civil law[65]), the approach is sometimes different. There are jurisdictions where an "agreement to agree" shall be considered binding if it contains all the elements necessary for the second agreement.

[64] *See* Glossary.
[65] *See* Glossary.

Letters of intent: binding or non-binding

The basic legal question with letters of intent and similar documents is whether they are binding or not. The answer to this question depends to a great extent on the intention of the parties, on the wording of the document, and on the legal system according to which the document is to be interpreted. The parties should very carefully see to it that such preliminary agreement is either clearly non-binding, or otherwise binding, according to their underlying intention.

Sometimes parties make an agreement "subject to formal contract". In common law jurisdictions it is very often held that such arrangements are not binding. However, it is considered that the courts may judge whether the parties have really intended the conclusion of a formal agreement to be the condition for the contract, or have merely expressed only a desire to make such a formal agreement without it being essential for the existence of the contract. But if the parties made an arrangement and stated that the arrangement is valid "subject to contract", it is generally considered that they did not intend to be legally bound by that arrangement.

In conclusion, if the parties did not clearly express themselves in the preliminary agreements, the courts may be put in a position to interpret their intentions. Such interpretation shall be made in accordance with the law applicable to that relationship and may bring entirely different results from what the parties really wished to achieve and what they had expected.

3.4.5 Confidentiality, secrecy and non-disclosure agreements

The issue of confidentiality has three main distinct aspects that may emerge on different occasions throughout the process of implementing a joint venture.

The first aspect is that, while negotiating a joint venture, the parties may wish and agree to keep the existence of the negotiations confidential until they consider that a proper announcement on the proposed joint venture can be made. The second aspect is that the parties will wish that information supplied during the negotiations be kept confidential. This is particularly important because, to advance the process, each party may have to disclose sensitive business or technology-related information in order to allow the other party to make its own assessment of its interest in proceeding further in their contacts and arrangements. The confidentiality (or secrecy, or non-disclosure) agreement, or an otherwise suitably worded clause in the letter of intent or memorandum of understanding, is intended to prevent the party which received such information from using it if the process is terminated and the joint venture does not materialize. The third aspect is an obligation on the parties and the joint venture company itself to treat certain information as confidential. This aspect is usually dealt with in the joint venture contract and the agreements for employment of the joint venture staff.

A preliminary non-disclosure agreement may also be concluded, individually or jointly, with selected employees of the prospective licensee or technology recipient. The agreement may call for an initial evaluation of the information by one individual of suitable

Confidentiality agreements: the essence

The essential terms of a preliminary confidentiality agreement are undertakings by the prospective partner:

- Not to communicate or disclose know-how obtained during the preliminary negotiations
- To use it only for the purpose of assessing the desirability and value of a licence.

Confidentiality agreements are mainly aimed at protecting the interests of the parties in the event that they disclose technical know-how, business data, or any other information to their negotiating partners which they wish to be kept secret.

standing selected by the prospective licensee. The initial evaluator then advises, on the basis of the information received, whether or not the technology is of interest. If it is not, he agrees not to disclose the information received; if it is, the potential licensee, as well as the initial evaluator, agree not to use the information and to restrict its disclosure until an agreement is executed establishing the terms and conditions for its use and the acquisition of the technology.

3.4.6 Incorporation: forms and advantages

Since a joint venture is implemented as a separate legal entity, one of the first steps in a joint venture agreement is to choose the legal form to be adopted for such a legal entity.

The legal form of the joint venture depends on the law of the country where the entity is to be established. In most countries, there are special codes or company laws which regulate what forms of incorporation or partnership will be allowed on the territory. Parties willing to agree on the form of the future joint venture entity can only select among the forms allowed by the relevant code or company law.

Advantages of incorporation

- The joint venture is a new legal entity and is therefore officially separate from its founders;
- A legal entity can conclude contracts, acquire rights, undertake obligations and act in business under its own name;
- Since the legal entity is a separate body, the founders have no liability for the debts of the new legal entity;
- The liability of joint venture participants is limited to the amount of capital they have invested.

The main advantage of incorporation is that the joint venture, as a new legal entity, is legally separate from its founders. Therefore, the founders have no liability for the debts of the joint venture. As a legal entity, the joint venture can conclude contracts, acquire rights and undertake obligations, sue and be sued in the courts and administrative organs and can generally act in business and commerce under its own name. Founders of a legal entity are not liable for the debts of the entity, except with the capital they have invested into the entity. Of course, they can guarantee the debts of the entity, but in such a case they would be liable as guarantors and not as founders.

A popular form of limited liability company is the German "Gesellschaft mit beschränkter Haftung" (G.m.b.H.), which in French law is a "société à responsabilité limitée" ("S.A.R.L."), in English law a "private company", and in the United States law a "close corporation". This form is very suitable when there is a smaller number of participating partners who wish to limit their liability through the corporate form of a legal entity, but do not wish to raise the capital for the corporation through wider public subscriptions. In such a corporation the capital is divided among the members in quotas and no shares are issued to them. The capital which partners contributed to the corporation can be transferred to third parties only with the agreement of other members and not through transferable shares as is the case in joint stock companies.

The incorporated form which is very often used in market economies for large undertakings, is the "joint stock company limited by shares" of English law, or the "joint stock company" of United States law, or the "Aktiengesellschaft" of German and Austrian law, or the "société anonyme" of French law. Such incorporation is always a legal entity for which shareholders are never personally liable. The capital of such a joint stock company is expressed in monetary terms and divided into shares, which are, in principle, freely transferable.

3.4.7 Foundation documents

These are the documents which are required to incorporate the joint venture as a new company and can include the joint venture contract and the articles of association which altogether form the constitution of the company.

The articles of association govern the internal affairs of the company and commonly cover such items as voting rights, the power of management and the board of directors, the powers of the general manager, dividend payments, share transfer rules, change of capital structure, and so on. The joint venture contract and the articles of association should be drawn up in accordance with the requirements of host country legislation. The law may contain a list of the questions and issues which must be regulated in both these documents. On the other hand, the parties can include, both in the joint venture contract and in the articles of association, any other provisions which they wish to agree on, provided that they do not conflict with the stipulations of company law. This principle is set forth in the joint venture laws of certain countries, complementing the list of items which the articles of association must contain.

Depending on the legal system (common law or civil law[66]) and on the jurisdiction, other related terms can be found, such as memorandum of association or by-laws, with the same or slightly different meaning as articles of association.

[66] *See* Glossary.

The requirement that foundation documents include both the joint venture contract and the articles of association is contained in some national company laws, but there are also jurisdictions (e.g. civil law jurisdictions) that require (or allow) that a company's incorporation be based on a single document called the charter or constitution of the company. In the UK, for example, The Company Act 2006, which is expected to be brought into force in October 2008, will provide for the requirement of a single constitutional document for the incorporation of a UK company instead of two separate governing documents[67]. Some authors believe that having the constitution implemented in a single, unified document makes it easier to use, increases clarity and reduces the chance of conflict.

Foundation documents

As a rule, the documents required to incorporate a joint venture are the joint venture contract and the articles of association. The national company laws contain the requisites that govern contents and issues to be included in those documents. The parties can include additional provisions, both in the joint venture contract and in the articles of association, provided, however, that such provisions are in compliance with the laws of the country.

When negotiating the structure and contents of the joint venture documentation, the parties should, therefore, take into account the provisions of the host country legislation and, if both a joint venture contract and articles of association are to be drawn up, agree within the framework of the stipulations of the applicable law on what provisions will be included in the articles of association and what will be left to be agreed in the joint venture contract or any other agreements which will be concluded for the realization of the joint venture objectives.

3.4.8 Ancillary agreements

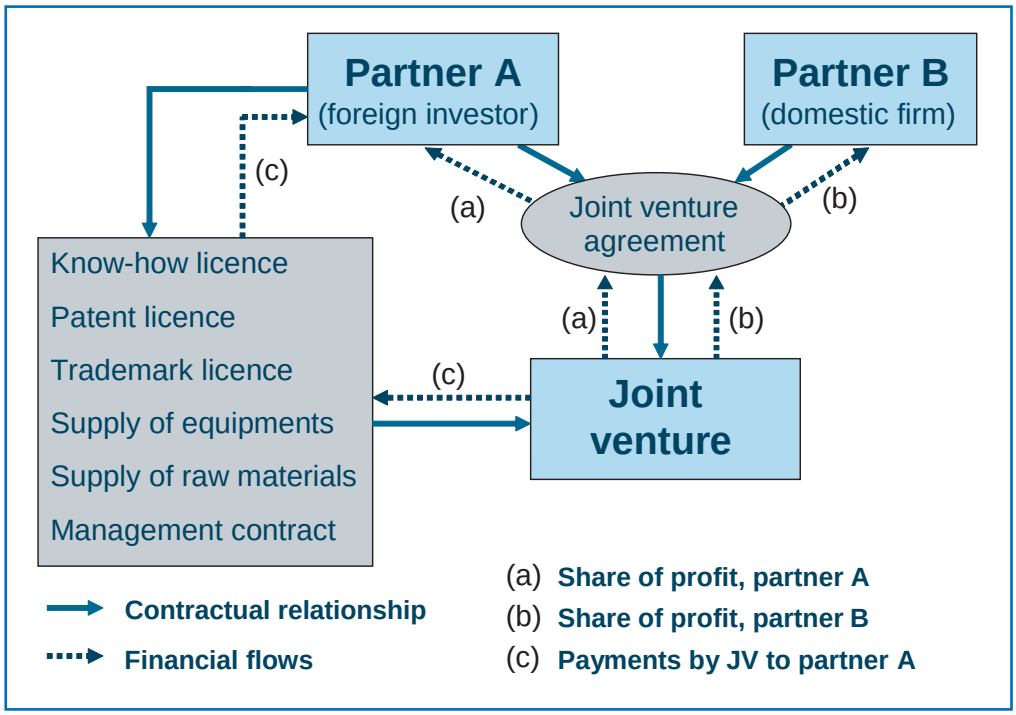
A joint venture agreement is usually accompanied by a package of other agreements concluded between the joint venture company and one of the partners.

As a rule, joint ventures where the partners are a foreign investor and a domestic company of a developing country are established mostly because the partners from developing countries need modern technology in order to set up a competitive and profitable industrial undertaking. In other words, the joint venture needs technology and skills from the foreign partner, which are provided through specific arrangements between that partner and the joint venture, for example:

- contracts for the purchase from the partner of machinery, equipments, raw materials, components, etc., that are necessary in its own production;
- licence contracts whereby the joint venture acquires the right to use the partner's patents, know-how or trademarks;
- contracts for services, such as the installation or supervision of the installation, technical assistance, training or management.

[67] *Source:* Wikipedia.

Figure 3.5 The package of contracts in a joint venture



There can also be contracts between the joint venture and any of the partners for the sale of the manufactured products or provision of services.

The arrangements mentioned above are, naturally, a part of the joint venture agreement and may therefore be included in the structure of the joint venture contract, but they are often formulated and concluded as independent agreements. In this connection, it is important to keep in mind the following realities and guiding ideas:

- The technology, services and other inputs provided by one of the partners to the joint venture represent flows of money from the joint venture to the supplying partner, and their prices should reflect reasonable market values, otherwise, if they are overpriced, they will distort their share of the joint venture profit to the detriment of the other partner.
- Ideally, the terms of such contracts and supplies should be negotiated and established on an arms-length basis, or through competitive bidding, although this principle may not be easy to follow, mainly when proprietary technology and equipments are involved.
- In line with what was recommended above in relation to the "valuation of inputs", the parties should also carefully negotiate the ancillary agreements and assess the transaction costs through the use of appropriate evaluation methodologies.
- Last but not least, these agreements should be concluded at the same time as the joint venture agreement and not afterwards, in order to avoid a situation where the balance of negotiation no longer exists and the supplying partner is in a position to set conditions at will.

Review of chapter 3.4

Selected issues for consideration

When planning for the establishment of a joint venture in a foreign country, the parties concerned should pay attention to the national laws of the host country and consider how they may impact on the life of the joint venture company.

In a joint venture, different kinds of assets can be invested, both tangible and intangible. As a rule, national legislations require that the valuation of such assets has to be "realistic" and carried out according to acceptable rules.

The foundation of a joint venture projected to become a solid and durable undertaking rests on the complementarity of the partners' contributions and on the partners' recognition that they need each other and that none of them alone would be able to contribute all the required inputs.

Over time, the stability or instability of the relationship between the partners, or the balance of power, is determined by their perceptions of the relative importance of each partner's contribution, and whether the actual operation of the joint venture is fulfilling the aspirations of each partner.

Although developing country partners are currently perceived as the more vulnerable to shifts in the balance of power, they may nevertheless have or develop strengths that can be used to keep and eventually increase their relevance in the joint venture.

The basic legal question with letters of intent and similar documents is whether they are binding or not. The answer to this question depends to a great extent on the intention of the parties, on the wording of the document, and on the legal system according to which the document is to be interpreted.

Confidentiality agreements are mainly aimed at protecting the interests of the parties in the event that they disclose technical know-how, business data, or any other information to their negotiating partners which they, the disclosing partner, wish to be kept secret.

The essential terms of a preliminary confidentiality agreement are undertakings by the prospective partner:

(a) not to communicate or disclose know-how obtained during the preliminary negotiations; and
(b) to use it only for the purpose of assessing the desirability and value of a licence.

The main advantage of incorporation is that the joint venture, as a new legal entity, is legally separate from its founders. The founders have therefore no liability for the debts of the joint venture except to the extent of the capital they have invested in it.

Foundation documents are the documents which are required to incorporate the joint venture as a new company and can include the joint venture contract and the articles of association which altogether form the constitution of the joint venture company.

A joint venture agreement is usually accompanied by a package of other agreements concluded between the joint venture company and one of the partners. These ancillary agreements are naturally a part of the joint venture agreement and may therefore be included in the structure of the joint venture contract—but they are often formulated and concluded as independent agreements.

3.5 The joint venture agreement: overview of drafting issues

Previous sections have presented substantial elaboration on various aspects that have to be negotiated, agreed upon and made part of the joint venture contract. The purpose of this section is to present a comprehensive annotated checklist of issues that have to be considered in a joint venture agreement. Within the overall scope of the contractual agreement, they will not necessarily be dealt with in a single agreement but, eventually, in several of the agreements referred to in section 3.4.7 and 3.4.8 above.

As a supplement to the present checklist, and for the sake of providing illustration and guidance to the users of this package, we present several sample contracts in the Annex. It should be noted, however, that this kind of material should be used with caution. Each agreement is specific to the parties involved and is related to a particular set of circumstances that are unique and irreproducible. Consequently, and as highlighted in section 4.2.4, any sample agreement, if used as a guiding tool, always requires substantial adaptation and redrafting to suit a specific concrete situation.

3.5.1 Formation of the joint venture

The parties

The joint venture contract should include, as a rule at the very beginning, a clear identification of the parties with a description of their legal status, and the capacity and/or authorization of each of them for the conclusion of the contract. It is essential that the description of the parties be accurate since that description identifies the bearer of the legal rights and obligations which are created in the agreement.

Preamble, or recitals, or whereas clauses

A joint venture agreement usually has an introductory part, often in the form of a preamble, where the partners state the basic historical facts relating to the establishment of the agreement. Here, they often state what they aim to achieve by entering into the joint venture, what basic capabilities they have, what the objective of the legal entity which they will jointly create should be, the assumptions under which they are entering into the joint venture, and any other statement explaining the fundamental reasons and grounds for their association.

The recitals or whereas clauses

The recitals have no binding character and their inclusion in the contract is not indispensable; but they are useful because they spell out the background of the agreement and the intention of the parties and can therefore have a valuable role in the interpretation of the contract in the case of doubts or in the resolution of disputes.

Although such statements, or recitals, as they are known, have no binding value and may seem superfluous, they are really important because they reflect the very fundamentals of the joint venture together with basic intentions, expectations and contributions of the parties at the time when they agreed to enter into the joint business. If any one of these basic ingredients does not materialize in the future, or becomes a cause of dispute, the recitals will show the original contractual intention of the parties and will therefore be useful for the resolution of the dispute in the court of law.

The recitals are also known as "Whereas clauses" because they are often formulated in a sequence of sentences which start with the word "Whereas", as can be seen in the sample agreements presented in the annex.

Legal form, name and location

(a) *Legal form:* In some countries, the parties can choose between two or more corporate forms in which the joint venture activities will be carried out, and in certain countries, the same form is used by all joint ventures. The parties should specify in the joint venture contract the appropriate form they wish to have. The necessary details regarding the practical steps to be taken for the incorporation and related matters should also be agreed upon (*see* section 3.4.6 above and the section "Incorporation and articles of association" in 3.5.1 below).

(b) *Name:* A joint venture requires a name. For a number of reasons, including business-related reasons, the name under which it will operate is often of importance to the parties. Furthermore, the name will also have to be included in the incorporation documents.

If a joint venture is to include the name of any party to it in its corporate name, trade name, trade or service mark, the owner of the name or mark will, in principle, insist on a licensing agreement setting forth the terms and conditions for the use of such name or mark by the joint venture.

(c) *Location/seat/registered office:* The joint venture contract should specify the place in which the joint venture is going to have its registered office. There are operational, financial and legal considerations in determining where to locate a joint venture within a given host country.

Definitions

A section with definitions of keywords or terms with impact in the contract and which may have different interpretations is frequently found in international contracts, and joint venture contracts are not an exception to this practice. Agreement by the parties on the definitions adopted for such keywords or terms can be of the utmost importance because many of the legal and economic concepts used in the host country may differ considerably from those used in the foreign investor's country, and vice versa. Precise definitions of the keywords and terms will ensure uniform interpretation and unambiguous understanding by all parties concerned. For example, if the contract in its various clauses has to make reference to the "product", in the section "Definitions" there should be a clear and unequivocal explanation of what the that word means in terms of name, composition, characteristics, packaging, etc. Another example: If the word "day" has to be used in the contract in connection with a particular input, output, fee, etc., it has to be defined whether it means "calendar day", "working day", a "continuous period of 24 hours", etc.

Objectives and scope

The parties may wish to set out, in more or less detail, the joint venture's objectives, possibly taking into account the host country's development policies and goals.

The joint venture contract should also define the scope of the business activities in which the joint venture is to engage. It may be necessary to specify the products to be produced (or services to be rendered) by the joint venture in a separate section (*see* section 3.5.7 below). Similarly, provisions relating to the purchase of raw materials, components, etc., and the marketing of the products (or services) of the joint venture may require a chapter of their own (*see* section 3.5.8 below). The objectives and the scope of the joint venture can also be stated in the preamble (or recitals, or whereas clauses).

What each party is aiming at

The local company could envisage: developing modern production and marketing; obtaining advanced know-how and management skills; and expanding operations in the domestic market and possibly into the foreign markets as well.

The foreign company may aim at: obtaining favourable factor conditions[a] in the host country as well as tax facilities and other incentives; gaining market expansion both in the host country and in global markets by obtaining products manufactured at favourable costs; and achieving additional income through technical and management fees and by eventually supplying other inputs.

The government may be interested in: providing employment for the local labour force; utilizing available natural resources and increasing the manufacturing value-added in the country; upgrading the local level of technological sophistication; and promoting exports and linkages with local suppliers.

[a] *See* Glossary.

The parties' contributions

Complementary contributions of resources by the parties provide a firm basis for a viable joint venture and will be determined by the industry in which they are involved, their products or product lines, their business orientation and many other factors. In many manufacturing operations, the major contribution of a foreign investor comprises manufacturing technology, product know-how, patents (if any), business expertise, technical training and management development. Important contributions from foreign investors could also be trademarks and brand names.

The local partner in a manufacturing joint venture usually contributes some combination of capital, management, knowledge of the environment of the host country and the market, contacts with the government, financial institutions, local suppliers and labor unions, and some marketing capabilities.

The parties will have to give due consideration to the above when negotiating the joint venture's capital structure and their respective contributions, which are further discussed in the following paragraphs.

Subscriptions. The joint venture contract should set out the ownership interests or the number of shares which each party will subscribe, the price of each share, when applicable, and the total price of the ownership interests or set of shares to be subscribed by each party.

Cash payments. The parties should agree in the joint venture contract on the manner in which cash payments for the ownership interests or share are made. Normally, they are made to a bank account opened specifically for this purpose.

Non-cash contributions. In most countries, either corporate law or joint venture legislation expressly allow payments for share subscription to also be made in forms other than cash, that is, in kind, in services, in industrial property rights, etc. Often, the law which permits other forms contains stipulations on how these contributions will be assessed.

Contributions in kind and their valuation

Contributions in kind will often include buildings, structures, machinery, equipment and other assets, rights to use land, water and other natural resources, as well as other proprietary rights (including those to use inventions and know-how), and money assets in the currencies of the parties' countries and in freely convertible currencies.

The values of such contributions should be established and audited on the basis of accepted practices in order to ensure that they reflect their current market prices.

Therefore, if the parties agree that part of the capital contributions will be made in a form other than cash, the joint venture contract should describe and indicate the value of each such contribution. The documentation which substantiates the indicated values of the contributions should be referred to in the joint venture contract and, where appropriate, appended thereto. It is common that, under host country laws, the value of contributions in kind may be agreed upon by the parties (with due regard to world market prices), but often subject to review by regulatory authorities or an auditor.

Within the framework of the applicable law, the joint venture contract should also contain stipulations on how and when the different contributions will be handed over to the joint venture and when these contributions will be entered in the books of the joint venture. (On this topic, *see also* section 3.3.2 above).

Transfer of shares; change of partners

Joint venture agreements are concluded on the basis of personal knowledge and trust developed between the partners. It is therefore important for the partners to secure the stability and continuity of their contractual relations through the inclusion in the joint venture contract of special provisions for the transfer of the joint venture's shares from one partner to the other or to third parties.

Transfer of shares and change of partners

When drafting provisions related to the transfer of shares, rules of the host country's laws, if any, pertaining to the following may have to be considered:

- limits to the permitted shareholding;
- approvals required by authorities;
- consent required by other parties;
- pre-emptive rights of other parties.

The joint venture contract should also contain provisions aiming to ensure that the new partner is bound by all the terms and conditions of the joint venture agreement.

There might be different reasons for the transfer of shares or change of partners. For example, one of the partners may decide to wind-up its business; or may have become bankrupt or insolvent; or may wish to find a more compatible partner or a partner with new or better technology; or may need to sell its shares because he wishes to enter a new line of business and needs cash.

Whatever the reasons for the transfer of shares or change of partners might be, the joint venture agreement should provide for the procedures to be followed in such cases. Sometimes it is the foreign investment laws of the host country that provides mandatory rules, such as the duty of the partner who wishes to leave, to first offer the other partner the option to buy his shares ("right of first refusal"). Only if the other partner does not buy is the first partner allowed to offer his shares to third buyers but under the same conditions as made to the other partner.

In any case, it is important to provide in the contract that the new partner is bound by all the terms and conditions of the joint venture agreement. In such a case, if there are share certificates, each one will contain a statement to the effect that all shares are issued in accordance with the joint venture agreement and can only be transferred under the condition that the transferee formally accepts all the provisions of the joint venture agreement.

Duties during formation and operation

A clear allocation of the parties' respective responsibilities will help to avoid problems and disputes at a later stage. The drafters of joint venture contracts sometimes prefer to list the parties' respective responsibilities in one section. This approach results in two basic questions. First, should such a list be comprehensive and specify all the responsibilities of the parties or should it only contain supplementary responsibilities not specified elsewhere in the contract? Second, should it contain binding contractual responsibilities or only "best efforts"[68] type undertakings, for example to provide assistance, or should it contain both? These questions require a clear, unequivocal answer in the form of properly drafted clauses.

[68] *See* Glossary.

Duties to be allocated to the parties

Issues to be dealt with in a section about the parties' responsibilities during the formation and operation of the joint venture could pertain, for example, to:

- obtaining required approvals and licences;
- registering the joint venture company;
- procuring supplies, equipment and facilities;
- recruiting local and foreign personnel;
- raising the needed financial resources.

More elaborate provisions on some of these issues and other issues will have to be included elsewhere in the joint venture contract.

Incorporation and articles of association

Pursuant to the previous section, the joint venture contract should indicate which of the parties will be responsible for the incorporation of the joint venture. The local party, usually being in the best position to organize the incorporation, will, in principle, be assigned to this task, but the parties may wish, for specific reasons, to adopt some other way of proceeding in this matter.

Even if only one party is made responsible for the proceedings, it may be advisable to state expressly in the joint venture contract that the other party shall have to make available such assistance (providing information, certificates, signatures, etc.) as will be necessary for the proper incorporation of the joint venture.

The articles of association of the joint venture should be drawn up in accordance with the requirements of host country legislation on the appropriate legal form. As a rule, such legislation sets forth the issues which must be dealt with in the articles of association. Usually, the partners can also include provisions in the articles of association other than those required by law, provided that such provisions are not in contradiction with the law (*see also* sections 3.4.6 and 3.4.7 above).

Implementation schedule

In order to provide for an orderly implementation of the necessary investments, the parties should include in the joint venture contract a time schedule which sets out the dates by which the various measures must be undertaken and finalized. The schedule could cover such items as measures necessary for the completion of the approval procedure, incorporation of the company, conclusion of agreements accessory or complementary to the joint venture contract (such as licence, construction, lease, leasing, purchase, employment contracts, etc.), taking possession of the facilities where the company is to operate, completion of the technical layout(s) for the plant, installation of the produc-

tion equipment, training of the company personnel, testing and commissioning of the plant, etc.

Planning and coordination

The parties may wish to include provisions in the joint venture contract setting forth some of the basic business policies under which the company is to be operated. Here, also, the respective host country regulations should be taken into account. The need for planning and coordination may relate to such areas as:

General business principles. The laws of certain countries include provisions describing the general business principles to be observed by a joint venture company and according to which the joint venture shall operate, for example on the basis of full cost accounting, being self-supporting and—in particular regarding foreign exchange requirements of the joint venture—self-financing.

Internal business planning. The joint venture contract should also lay down the basic principles regarding the planning of the business operations of the joint venture. Such planning should, of course, be carried out in accordance with the requirements, if any, of the applicable law of the host country, for example the requirements of the taxation law.

Issues which can become the subject matter of internal business planning could include decisions about prices, the quality of output, depreciation costs, etc. Systematic planning is likely to be required in the area of purchases of raw materials and components, and subcontracting.

Coordination with host country authorities. Joint ventures should, in principle, streamline their activities with the host country economy. In some countries, this is not simply a matter of following a useful practice but could also be required by law.

The parties should, therefore, carefully examine host country legislation and practice regarding the coordination of joint ventures' activities with the relevant authorities. Having done this, they should consider whether provisions should be included in the joint venture contract specifying the principles which will be followed in such coordination. Host country legislation may regulate the procedure to be observed in this respect.

Areas for planning and coordination

General business principles: e.g. covering the rules governing cost accounting, foreign exchange requirements and financing;

Internal business planning: e.g. on purchases, subcontracting, prices and quality of outputs, depreciation costs, etc.;

Coordination with authorities: should be considered and followed as a useful practice and sometimes is prescribed by law;

Coordination with partners: necessary in the case of contractual relationships between the joint venture company and the partners.

Coordination between the joint venture company and its partners. As part of their joint venture, the partners may have to agree on the questions related to the coordination of the activities of the joint venture with the respective activities of each of the partners. For instance, it may be necessary to include provisions in the joint venture contract regarding the delivery by one partner of goods or services to the joint venture and the respective terms to be applied thereto, or regarding the competing activities of the parties and the joint venture in those fields where their activities may overlap.

3.5.2 Organization and management

Statutory organs and division of powers

The rules regarding the statutory organs of joint ventures are stated, depending on the jurisdiction in question, either in the general company laws of the host country or in the specific regulations for joint ventures with foreign participation, or in both. In a joint venture, there are normally two managing bodies, one being the highest decision-making organ, the other being responsible for the day-to-day management of the joint venture.

Organization of the joint venture: a central issue

A central issue which the parties will have to regulate is the organization of the joint venture. This involves agreement not only on the composition and functioning of the statutory organs of the joint venture but also on its operational structure, on the functions and responsibilities of its various departments and on the human resources which will be available to it.

Before starting negotiations on the organization of the joint venture, the parties should therefore get acquainted with the relevant provisions of the host country legislation. Once they have identified the various organs prescribed—or allowed—by the law, they should find out exactly which matters fall within the jurisdiction of each of the different organs and to what extent the rules establishing the internal division of powers and responsibilities between such organs are mandatory and to what extent the parties may have discretion on the terms of their agreement.

An important aspect of the division of powers and responsibilities between the various joint venture organs is the question of control of the activities of the different organs and the principles that govern the collective and individual liabilities of the members of the organs for the activities they have undertaken in their statutory capacity. Here, also, the parties should have a clear picture of the environment in which they are to operate and, to the extent necessary and permitted by the country's regulations, agree upon these matters in the joint venture articles of association.

The management: composition and nomination

The joint venture agreement is the document in which the joint venture partners lay down the basic rules for their association. In some ways, a joint venture agreement could be compared to a "constitution" of partners.

National laws which provide the rules of incorporation also provide the rules on how different corporate forms are to be managed. However, when partners agree to enter into a joint venture, they also wish to know what their influence will be in the management of the future company. This means that the partners can, in their joint venture contract, agree on the basic question of future management, such as which one of them will nominate the general manager of the future company, how many members the management board of the future company will have, and who will nominate or elect how many members of that board, etc.

The management and the rules of nomination

In principle, the party with the majority equity stake will be the one with the right to nominate the general manager unless the host country laws determine otherwise. The parties will have to negotiate and agree on the composition of the board of directors, the functions assigned to each of the Board members, and the positions for which the parties are entitled to nominate the directors.

Joint venture partners may wish to limit the authority of the management or may wish to introduce requirements of special approvals of certain decisions of management organs, etc. For example, the joint venture agreement may provide that the management of the joint venture company may not make certain decisions without the agreement of the joint venture partners, or without approval of a member of the supervisory board. All such provisions can be made only in accordance with the applicable national laws.

Taking into account the applicable rules, the parties may include in the joint venture contract, or in the articles of association, as the case may be, provisions regarding the allocation or the number of management posts in the joint venture organs, or specific posts in such organs, between the parties.

Term of office

The company laws or the joint venture laws of different countries have different rules for the term of office of the members of the various organs of joint ventures. These rules should be studied and, if the parties want to agree otherwise and deviation from them is possible, a corresponding provision should be included in the charter.

Quorum and manner of acting

The parties may wish to include provisions in the articles of association regarding the quorum necessary for the making of decisions in the management organs. Such provisions might stipulate, for example, that the quorum necessary for the transaction of any business in the respective organs consists of a majority of the members of that organ, provided, however, that a least one appointee of each joint venture party is present.

Defining when unanimous decisions are required

With regard to the manner of acting, some joint venture laws stipulate that the parties must define in the articles of association of the joint venture the questions on which unanimous decisions are required. The law itself may state all the basic decisions on the activities of the joint venture which must be made unanimously by all members of the organ concerned. If the law of the host country is silent on this point, it would seem that a requirement of unanimity can be included in the articles of association, if the parties so wish.

3.5.3 Financing and financial policy

Financing plan

The joint venture contract should define how the setting up of the joint venture and the implementation of its operations will be financed. This could be done in the form of a financing plan. When drawing up the financing plan, the applicable host country regulations should be taken into account.

Sources of financing

The sources of financing may be shareholder contributions (equity or debt), i.e. shareholder loans or loans raised in local or foreign currency from local or foreign banks. The parties may wish to stipulate rules for debt financing (including shareholder financing obligations) in the joint venture contract, in particular for the joint venture's way of dealing with borrowings from banks.

The joint venture agreement usually contains a statement by the parties declaring what the financial policy of the joint venture shall be: whether the primary interest shall be to distribute profits or first to build up some reserves and later to distribute the profits. Consequently, the issue is retention of profits vs. distribution of profits.

Debt to equity ratio

One important issue in the sphere of financial policy is the relation between debt and equity, i.e. the proportion of loans which the joint venture will take to finance its construction of the equity which will be used for the same purpose.

As a rule, investments are financed only partly from equity invested by the partners and partly from loans which the partners, or one of the partners, or the joint venture itself, take from local or foreign banks.

The appropriate relation between debt and equity in any given project depends on the economics of the project and on the economic strength of the partners. In certain industries, it is economical to have a debt to equity ratio of 1:1, in some 2:1, while some will support a ratio of even 3:1.

Avoiding high debt to equity ratio

If the debt is high compared to the equity, there is no cushion in equity for coverage of the debt. Furthermore, a high debt might mean excessive loan costs, to the detriment of the joint venture profits. In particular, if the loan funds are obtained from one of the partners at a high interest, that in practice means an accrued profit to this partner while the profits of the joint venture itself will correspondingly be diminished and so will the other partner's share in the profits.

Transfers of profits and of invested assets

For foreign investors, one of the most relevant issues in joint venture arrangements is the question of transfer of profits, of invested assets and of the increased values of their capital investment. This is a subject that mostly relates to the foreign investment regulations, and there is not much that the parties can do about it from the contractual point of view; but many foreign investors will certainly judge the attractiveness of a country by the freedom to remit profits and other entitlements related to their operations, as is the case with licensing and management fees.

Concerning the transfer of the invested capital, it is usual in joint venture contracts to agree that the foreign investor will have the right to transfer the counter value of the invested cash amounts and other capital investments in the values recognized in the joint venture contract. That means that the invested technology (know-how, trademarks, patents, etc.) and the invested tangibles (land, machinery, equipment, spare parts etc.) which have been invested and not provided under licence, will be expressed in the joint venture agreement in certain value terms, and that the expressed value represents the value of the invested capital. Since the invested capital is to be returned to the parties at the termination of the joint venture (provided that the joint venture is not bankrupt and that the debts exceed the assets), and after all the accounts are settled, the foreign investor will be entitled at that time to receive the counter value of all of their invested capital.

At the end of the joint venture, the question may also arise of the true value of the joint venture, particularly in cases where its value has become higher than the amount of the nominally invested capital. In such cases, the foreign investor may wish to get their share of the increased joint venture's worth.

3.5.4 Setting up facilities and operations

The following discussion is based on the assumption that the joint venture will set up new manufacturing facilities. Frequently, however, one party is in a position to contribute facilities, which may have to be expanded or upgraded to suit the objectives of the joint venture. Any expansion or upgrading usually involves input, assistance and certain services from the other party.

Description of facilities

The parties should agree in the joint venture contract on the requirements for the joint venture facilities. In the case of a manufacturing plant, the contract might, for example, define—in an appendix if necessary—the production capacity of the plant and the margins for increase in the capacity, the required equipment, machinery, instruments, commissioning equipment and spares, and other items necessary in the production phase.

Plant building and other services

When appropriate, the joint venture contract might also define the terms and conditions for the construction of the building where the plant is going to be installed and state who shall take care of the necessary practical steps to have the building constructed and render any services required, such as assistance with the procurement and installation of the necessary machinery and equipment, commissioning of the plant, etc., and the terms and conditions for providing such services.

3.5.5 Accounting and auditing

In certain countries, joint venture laws contain rules dealing with accounting. These laws, or the general law on accounting, often leave room for the parties to agree on issues they consider important. Insofar as general principles and rules are not mandatory, the parties may wish to stipulate different principles and rules in the joint venture contract.

Depreciation rates

Under the rules of certain countries, depreciation rates applicable to domestic enterprises shall also be applied to joint ventures. However, under certain laws a different system is provided, or a specific treatment may be stipulated in the founding documents, or depreciation rates can be agreed upon by the joint venture partners.

Reserve funds

A joint venture must, under the rules of certain countries, create a reserve fund (sometimes called the risk fund) and other funds, for example a social fund. Other funds may be optional. If the law does not prescribe how these funds will be raised and used, this must be specified in the foundation documents.

Accounting and auditing issues

The rules of accounting and auditing may have to follow the rules set in the host country's law; otherwise, they can be agreed upon by the joint venture partners. They cover such aspects as:

- depreciation rates;
- reserve funds;
- rules of auditing;

and other matters such as the fiscal year of the joint venture, the rules of book-keeping, the language in which the books will be kept and the accounting principles to be followed.

Auditing

In some countries, joint venture laws contain provisions related to auditing. Such provisions, or the relevant provisions of the general law, may set forth, among other things, the rights and obligations of the auditor, including the right to inspect the books of the company and the obligation to have, in the circumstances described in the law, a meeting of the supreme body of the company convoked to an extraordinary meeting if this is deemed necessary.

Upon acquainting themselves with the provisions of the host country legislation, the parties should include the necessary stipulations in the joint venture contract, for example the number and nationality of the auditors, the manner of electing the auditors and their term of office.

Other matters

In addition to the issues dealt with above, the parties may wish to include provisions in the joint venture contract to regulate the following matters: the fiscal year of the joint venture; the language in which books will be kept; whether other books will be kept in addition to those required by the mandatory rules (if any) of the host country legislation; the accounting principles to be followed in such parallel book-keeping; and who shall bear the costs of such parallel book-keeping.

3.5.6 Staff recruitment and management

The functioning and the success of a joint venture essentially depend on the human resources allocated to it. In the perspective of the host country, the creation of a joint venture will have a social and economic impact through job creation and the upgrading of skills, and naturally the country's labour laws will have a bearing on the issues related to the joint venture's personnel. For the joint venture itself, other questions will have to be considered and dealt with in the joint venture agreement, namely those related to the selection and recruitment of staff, their required qualifications and training if any, and the eventual use of expatriates, etc.

Issues related to the joint venture staff

The joint venture contract should deal with the relevant aspects of the required staff resources and personnel management, namely:

Qualifications: definition of job description and requirements for the various posts in the organization;

Recruitment and dismissal: procedures for appropriate selection and grounds for dismissal of staff;

Key posts, e.g. expatriates: indication of posts that require expatriated personnel and for how long;

Aspects of training: designation of persons and posts that need special training and establishment of the related operational details.

Qualifications: It may be in the interest of the joint venture project that the parties agree on the qualifications which must be met by the occupants of given posts in the organization. Thus, it may be useful to incorporate in the joint venture contract, as an appendix, the job descriptions of, and qualifications required from, executive officers, key persons and other staff of the joint venture.

Recruitment and dismissal: It may be necessary to agree on the principles to be applied when employees are recruited for the joint venture, so that a suitable and qualified work force will be engaged, thus ensuring a proper and effective implementation of the transferred technology in the manufacturing of its products. Grounds for dismissal are, as a rule, specified in host country labour regulations, which may, however, allow that questions related to recruitment and dismissal of employees can be decided by the joint venture management.

Appointment of key persons, for example expatriates: If certain posts are to be occupied by persons originating in the organization of one or the other party, namely foreign expatriates, the joint venture agreement should specify these posts and indicate whether they shall be manned in the agreed way permanently or for a limited period only.

Conditions of employment: The joint venture contract should (with due regard to the host country's labor laws) contain sufficiently detailed provisions on the specific conditions of the employment contracts of the individual employees of the joint venture.

Training: Some of the persons to be engaged by the joint venture as employees may need to receive special training in order to meet the qualifications agreed upon by the parties or to absorb and implement the technology contributed by one of the parties. If this is the case, the joint venture agreement should set forth the necessary details of such training, for example:

- places where training is to take place;
- persons to be trained (with sufficient details specified as to their number and required qualifications, length of training, training language, etc.);
- aims of the training and the training program;

- measures to be taken by either party to ensure that the training can be carried out (e.g. procurement of visas, accommodation);
- how the costs, including traveling expenses, will be covered, and whether, against which risks and at whose costs the trainees (and possibly the trainers) will be insured.

3.5.7 Products

It may be useful, and even necessary, to specify, in a separate section of the joint venture contract, the products to be manufactured by the joint venture. This is particularly so in cases where the joint venture manufactures products using technology which is—or can be—applied by the party from whom the technology originates in the production of products other than those designated for the joint venture. The following discussion addresses this particular kind of situation.

Description, technology and standards

In order to define precisely the products which are to be manufactured by the joint venture, the joint venture contract should contain sufficiently detailed descriptions of each product in question. The agreement should also stipulate whether each product is to be produced by the joint venture on an exclusive or non-exclusive basis.

If the joint venture is to use specific technology in its production, including know-how, patents or patent applications, these should be identified in the joint venture contract. It may also be necessary to refer to the national standards and technical norms of the host country which will have to be observed in the production.

Terms and conditions of technology transfer

If either or both parties, are to make available to the joint venture their proprietary technologies to be used in the manufacture of the products, they will have to agree on the terms and conditions of that use. This they can do either in the joint venture contract or, as is more common, in a separate patent licensing or know-how licensing contract to be concluded between the joint venture and the grantor of the licensed rights.

If the latter alternative is used, the licensing contract can be concluded only after the joint venture has been formed and the persons entitled to sign for it have assumed office. On the other hand, it is usually in the interest of both parties that the terms and conditions of the licence contract are known and agreed to at the time when the joint venture agreement is signed. Also, host country authorities may require that such conditions are included in the joint venture application. Therefore, if a separate licensing agreement is to be concluded, it could be negotiated simultaneously with the joint venture contract, and an unsigned copy thereof could be appended to the joint venture contract. In the joint venture contract, the parties would make a reference to this licence agreement and agree that, as soon as the joint venture is incorporated, an identical licence agreement will be concluded between the joint venture and the grantor of the licensed rights (*see also* section 3.4.8 above).

Terms of technology transfer: should be known when signing the joint venture agreement

When one of the partners is the supplier of the technology to the joint venture, the conditions of the licence may be included in the joint venture agreement or established in a separate licensing contract between the supplying partner and the joint venture company after the joint venture has been incorporated. Whatever option is chosen, it is important that the conditions of the licence for the technology are agreed upon at the time when the joint venture agreement is signed and not afterwards.

Research and development

In addition to defining the technical specifications of the products, the know-how, the patents and the patent applications which will be used in their production, and the terms and conditions under which such use will be possible, the parties may wish to stipulate in the joint venture contract a number of other subjects relevant to the products. Particularly in the event that the products have a high technological content and the technology used is subject to rapid development, the parties may wish to make clear what principles will be followed regarding the research and development activities which will be necessary in order to keep the products competitive.

Product quality

Since it should be the aim of the joint venture that its products are competitive in the national and international markets, the parties may wish to agree in the joint venture contract, or in the licensing contract, on certain basic principles regarding the quality of the products. If the products are based on the technology of one of the parties, and if this party manufactures similar products, the contract could stipulate, for example, that the composition, specification, performance, durability and finishing of the joint venture products should correspond to those of the products manufactured by that party. The parties may also wish to agree in the joint venture contract, or in the licensing contract, on the remedial procedures to be applied in the event that the quality of the products manufactured by the joint venture does not meet the agreed standards.

Product liability

In addition to being contractually liable to wholesale and retail purchasers for defects in the products it manufactures and sells, the joint venture may have to face claims from the users or consumers of the products for the damage the products have caused to such users or consumers or their property. Such product liability claims do not require, as their basis, a contractual relationship between the joint venture and the plaintiff, but are founded directly on the laws of the country where the products are sold.

Owing to the seriousness of the problem, the parties should consider to which extent the risks involved can be covered through product liability insurance, and agree on the measures to be taken in this respect.

3.5.8 Marketing

Domestic and foreign markets

The ultimate success of the joint venture will depend on its ability to sell the products and obtain a reasonable profit on the sales. Some of the marketing problems the parties may be confronted with and some of the possible means of dealing with them are discussed below. The parties should agree on the basic principles which will be applied in the marketing of the joint venture's products, both domestically and abroad. The joint venture laws of some countries contain provisions regarding the marketing of the joint venture products and may distinguish between domestic and foreign markets.

Trademarks and trade names

Where the products to be manufactured by the joint venture have achieved market recognition under certain trademarks and trade names, such intellectual property rights are often important factors in ensuring both local and foreign market penetration for these products. As the foreign party, whose marketing policies in respect of the products licensed to the joint venture resulted in such goodwill, will participate in the profits of the joint venture, it may be willing to grant a licence for the use of these trademarks and trade names without charge, the more so if it already receives royalties for the licensing of patents and know-how.

3.5.9 Insurance

Depending on the joint venture's business, the parties may wish to stipulate in the joint venture contract the risks against which insurance shall be taken out, the amount of insurance cover and other relevant conditions. They may, however, prefer to leave this matter to the decision-making organ of the joint venture and provide only for guidelines in the joint venture contract.

3.5.10 Duration and termination

Subject to the host country's laws, the duration of a joint venture is a matter to be negotiated and agreed upon by the parties and must be stipulated in the joint venture contract and in the articles of association. Host country laws may prescribe a maximum duration or the parties may wish to stipulate a fixed term. Thus the duration may differ depending on the applicable laws and on the circumstances of different industries and projects.

Commencement date

The commencement date of the joint venture company must be distinguished from the effective date of the joint venture contract: while the effective date is subject to the parties' agreement and may be (and actually often is) a date later than that of the

About the duration of joint ventures

Joint ventures are usually established with an intention to have a long-term horizon, and there are cases of joint ventures which have been functioning well for decades. A typical joint venture agreement can provide for a duration of between 10 and 30 years, subject to renewal if the parties so agree; sometimes the parties do not even provide a time limit for the duration of the joint venture, under the assumption that the undertaking will run for as long as the business is viable and profitable.

conclusion of the contract, the commencement date is the date on which the company comes into existence as a corporate entity in conformity with local laws, for example registration in a company register. The parties will have to bear this distinction in mind when negotiating and drafting provisions relating to the duration and termination of the joint venture.

Termination

In the case of a fixed-term joint venture, the most obvious ground for termination is that of automatic termination by expiry of the term of the joint venture as established in the joint venture agreement.

In the case of a joint venture of indefinite duration, the parties will stipulate the possibility to terminate the joint venture in appropriate termination provisions.

The reasons for the parties wishing to terminate their relationship may fall under the following categories:

- One of the parties wishes to transfer its interest to another party or an outsider (*see also* "Transfer of shares; change of partners" in section 3.5.1 above).
- The contract has achieved its purpose, in which case the termination happens as mutually agreed by the parties.
- The parties are in deadlock and further collaboration has become undesirable or impracticable.

Consequences of termination

Since the joint venture is a separate legal entity, which was established in accordance with and following the provisions of the joint venture agreement, there are two distinct legal aspects related to termination:

- One is the termination of the joint venture agreement itself according to its own provisions.
- The other is the termination of the partners' legal relationship in the joint venture enterprise.

Possible reasons for termination

The parties may wish to consider the following events, among others, as making further collaboration undesirable or impracticable:

- serious breach of the joint venture contract or failure to fulfill it by one of the parties;
- inability to continue operations due to heavy losses over a specified number of years;
- inability to achieve the established objectives and no reasonable prospects of doing so;
- sustained event of force majeure significantly impairing the joint venture's operations;
- insolvency of one party or acquisition of one party by a competitor of the other party.

It is advisable that partners provide, in the joint venture agreement, the grounds for termination and the conditions under which such grounds can be invoked, for example insolvency, breach of contract, force majeure, unprofitability for a consecutive number of years.

Since the establishment of a joint venture requires a considerable level of investment, the parties may wish to restrict, in the joint venture agreement, the right to terminate at will in the earlier years by providing that there should be no termination for a specified period after formation.

The parties also need to agree on their interests and rights, and procedures for transferring such interests and rights in the event that one party is to withdraw from the joint venture, but the company itself is to continue (*see also* "Transfer of shares; change of

Consequences of termination

In the event of termination of the joint venture agreement, the parties can do the following:

- decide to liquidate the joint venture enterprise and to cease its operations altogether; in this case, the problem lies primarily in the division of the capital and the return of what can be saved from the enterprise through sales of its assets, collection of its receivables and payments of its debts;
- decide that one of them will take over the enterprise and continue to operate it without the participation of the other partner. In such a case, the leaving partner has to receive his dues and entitlements, for example those related to the invested capital or the technology made available to the joint venture company.

partners" in section 3.5.1 above). In particular, this means that, whether the company continues or is dissolved, a method of valuing the parties' interests will need to be agreed upon and the impact on ancillary agreements will have to be considered, together with the extent to which any rights or duties should survive termination or new rights and duties should be imposed.

If the parties decide to terminate the joint venture agreement, a number of outstanding issues will have to be settled, such as issues related to the transfer of profits, the situation of know-how and patents, and conditions for the return of invested capital. The settlement of those issues will be made in accordance with the terms of the joint venture agreement or in accordance with whatever agreement the parties may reach at the time of termination.

3.5.11 Miscellaneous clauses

The clauses which, in American legal jargon, are sometimes referred to as "boiler plate", i.e. clauses addressing standard problems and, therefore, found in most agreements irrespective of type, cover some areas which are important to international joint venture contracts. Nevertheless, they are frequently given summary treatment, sometimes to the great detriment of the parties, who should rather be careful and critical of their wording in order to avoid over-simplification and possible traps.

Some "boiler plate" clauses may be of special significance in a joint venture context and are, therefore, now discussed in the following sections:

Force majeure

Force majeure events are usually agreed to exonerate a party from a breach of contract, if such a breach is a result of a force majeure, event, i.e. if such an event prevented a party from due performance. The concept of force majeure is, however, not universal and in most jurisdictions it is not defined by law. The parties should, therefore, provide a general definition of force majeure events in the force majeure-clause, for example "unforeseeable and beyond the reasonable control" of the party concerned, and then specifically list as force majeure events those events that are of particular importance to one or all of them.

It should also be clearly set forth whether performance will be permanently excused or merely suspended for the duration of the event giving rise to force majeure. If performance is merely suspended, it might be wise to provide an option to terminate if the event exceeds a specified period or, probably better, to provide first for adaptation by negotiation.

Language

If the joint venture contract is written in more than one language (e.g. English and the host country's language), the parties may wish not only to include the usual provision that one version shall be authentic and prevail for the purpose of interpretation (or both

versions shall be equally authentic) but also to prescribe the language for communications between them and the joint venture company and the parties as well as the language for board meetings and the minutes of such meetings.

Changed conditions

One of the fundamental problems of long term contracts such as joint venture contracts is to reconcile two legitimate needs: stability and flexibility. The investor aims not only at protecting his investment but also at securing his profit expectations based on the contract and is worried about legislative or administrative changes that may modify his rights or obligations. The need for adapting a contract to a change in the surrounding circumstances may arise in different types of situations.

New events; new laws; renegotiation. Careful parties will endeavor to anticipate and define as many details as possible in the original contract but realize at the same time that there may be unanticipated changes of circumstances. They will, therefore, without prejudice to their right to resort to arbitration, want to build into the contract a flexible mechanism requiring and enabling them, by a common effort, to agree, for various reasons, to a material change of the contract in order to bring about a desired adaptation. Such a common effort by the parties to adapt a contract to a new situation through a material change of its terms is appropriately termed a "renegotiation", as opposed to a (more or less automatic, result-oriented) adaptation. In long-term contracts such as a joint venture contract, a clause providing for an obligation of the parties to renegotiate the contract, if this is warranted by a change in circumstances or the enactment of new laws, is a good means of building the required flexibility into the contract in the interest of achieving the goals and securing the smooth operation of the joint venture in the long term.

Change of circumstances: renegotiation

The parties should anticipate possible problems and provide for remedies in the joint venture agreement in case such problems occur; but there might be unexpected and unforeseeable changes of circumstances during the life of the joint venture, for example the enactment of new laws, which may require the renegotiation of the originally agreed terms in order to safeguard the parties' legitimate interests and expectations.

Periodic review. A renegotiation clause may require a triggering event for renegotiation. In order to minimize the danger of an "accumulation" of problems or even forestall them, it is useful to combine such clauses requiring a triggering event with a clause making the triggering event for a renegotiation certain by providing for a "periodic review" of the contract, its annexes, the operation of the joint venture, etc.

A periodic review of the joint venture contract and of its operation may not only be beneficial in this respect but, in the longer run, may also avoid the building-up of problems that in the end might cause the parties to resort to arbitration.

Conditions precedent and effective date

Often, the setting up of a joint venture will require the approval of some third party (e.g. a government authority), or some clearance will need to be obtained. This may be because the formation of the joint venture company and the underlying contracts, or the business to be conducted by the joint venture, or some step in setting up the joint venture need some official approval or consent.

The necessary approvals and consents will, unless obtained beforehand, need to be referred to in the contractual documents as conditions precedent to the obligations of the parties. The parties will, therefore, usually stipulate that the joint venture contract shall not become effective unless all required approvals and consents have been obtained, the date of which may be defined as the "Effective date".

It should be made clear who is responsible for applying for the various approvals and consents. As a rule, each party will accept responsibility for satisfying the conditions most closely under its control.

Applicable law

The parties to international contracts often seek to ensure that their respective rights and obligations are sufficiently clear not only by having properly drafted contracts but also by choosing the applicable body of substantive law. This choice of law is, subject to certain exceptions and restrictions, usually respected by national laws, the state courts and arbitrators.

One of the exceptions is that setting up and operating a company is, by necessity, governed by the company laws of the country of incorporation. This also holds, of course, for a joint venture company and its articles of association. The joint venture contract, however, and other (ancillary) agreements need not necessarily be governed by the host country's laws, unless they prescribe otherwise. In fact, though, relevant laws in developing countries often make the application of local law mandatory for joint venture contracts and possibly also for ancillary agreements.

In current practice, and insofar as a choice of law is permitted, the parties may have to consider the following:

- In principle the host country law will be applicable to the joint venture company, its articles of association, the joint venture contract, and also ancillary agreements to be entered into by the joint venture company with a local party and, in particular, with the local partner.
- For ancillary agreements to be entered into by the joint venture company with foreign parties, in particular with the foreign investor, however, a choice of law may be possible, and this is a matter for agreement by the parties.

Dispute resolution

The parties will, of course, endeavor to avoid disputes and try to minimize the risk of litigation by properly addressing all relevant issues in the joint venture contract. If a dispute arises, they may wish to resort, first of all, to alternative methods of dispute

resolution (in particular mediation or conciliation) rather than proceeding immediately to arbitration or to litigation in the court of law.

They will, therefore, make provision in the joint venture contract (and the ancillary agreements) for a dispute resolution mechanism by either a forum selection clause or an arbitration clause. To this extent, the dispute resolution clause in a joint venture contract will not be much different from that in other (international) contracts.

When drafting this clause, the parties must, however, not forget that there may be two types of dispute, each requiring a different approach:

- It may be an international dispute, if the problem arises between the parties (foreign investor and domestic partner) or between the foreign investor and the joint venture company.
- It may be a domestic dispute, if it occurs between the local investor and the joint venture company.

In many countries, different national arbitration institutions are competent to resolve domestic and international disputes; and international arbitration institutions, such as the International Chamber of Commerce, are competent only for the resolution of international disputes. The parties will, therefore, have to bear this in mind when negotiating and drafting an arbitration clause and will have to provide for arbitration by different arbitration institutions for domestic and international disputes.

Review of chapter 3.5

The joint venture agreement: overview of drafting issues

Each agreement is specific to the parties involved and is related to a particular set of circumstances that are unique and irreproducible. Consequently, any sample agreement, if used as a guiding tool, always requires substantial adaptation and redrafting to suit a concrete situation.

The recitals or whereas clauses have no binding character and their inclusion in the contract is not indispensable; but they are useful because they spell out the background of the agreement and the intention of the parties and can therefore have a valuable role in the interpretation of the contract in the event of doubts or in the resolution of disputes.

A section with definitions of keywords or terms with impact in the contract is frequently found in international contracts, and joint venture contracts are not an exception to this practice. Precise definitions of the keywords and terms will ensure uniform interpretation and unambiguous understanding by all parties concerned.

The major contribution of a foreign investor to a joint venture comprises manufacturing technology, product know-how, patents (if any), business expertise, technical training and management development. Important contributions from foreign investors could also be trademarks and brand names.

The local partner in a manufacturing joint venture usually contributes some combination of capital, management, knowledge of the environment of the host country and the market, contacts with the government, financial institutions, local suppliers and labor unions, and some marketing capabilities.

If the parties agree that part of the capital contributions will be made in a form other than cash, for example in kind, the values of such contributions should be established and audited on the basis of accepted practices in order to ensure that they reflect their current market prices.

In the event of transfer of shares and change of partners, it is important to provide in the contract that the new partner is bound by all the terms and conditions of the joint venture agreement. It is common that, by law, the remaining partner has the right of first refusal of the shares of the leaving partner.

In principle, the party with the majority equity stake will be the one with the right to nominate the general manager. The parties will have to agree on the composition of the board of directors, the functions assigned to each of the board members, and the positions for which the parties are entitled to nominate the respective directors.

The joint venture agreement usually contains a statement by the parties declaring what the financial policy of the joint venture will be: whether the primary interest will be to distribute profits or the aim will be first to build up some reserves and later to distribute the profits.

The appropriate relation between debt and equity in any given project depends on the economics of the project and on the economic strength of the partners. In certain industries, it is economical to have a debt to equity ratio of 1:1, in some 2:1, while certain industries will support a ratio of even 3:1.

The rules of accounting and auditing may have to follow the rules set in the host country's law and cover such aspects as: depreciation rates; reserve funds and other funds; rules of auditing; and other matters such as book-keeping, the language in which the books will be kept, accounting principles, etc.

When one of the partners is the supplier of the technology to the joint venture, the conditions of the licence may be included in the joint venture agreement or established in a separate licensing contract. Whatever option is chosen, it is important that the conditions of the licence for the technology are agreed upon at the time when the joint venture agreement is signed and not afterwards.

Joint venture agreements are usually established with an intention to have a long-term horizon, for example a duration of between 10 and 30 years, subject to renewal if the parties so agree. Sometimes the parties do not even provide for a time limit under the assumption that the undertaking will run for as long as the business remains viable and profitable.

In the event of termination of the joint venture agreement, the parties can do the following:

(a) decide to liquidate the joint venture enterprise and to cease its operations all together; and

(b) decide that one of them will take over the enterprise and continue to operate it without the participation of the other partner.

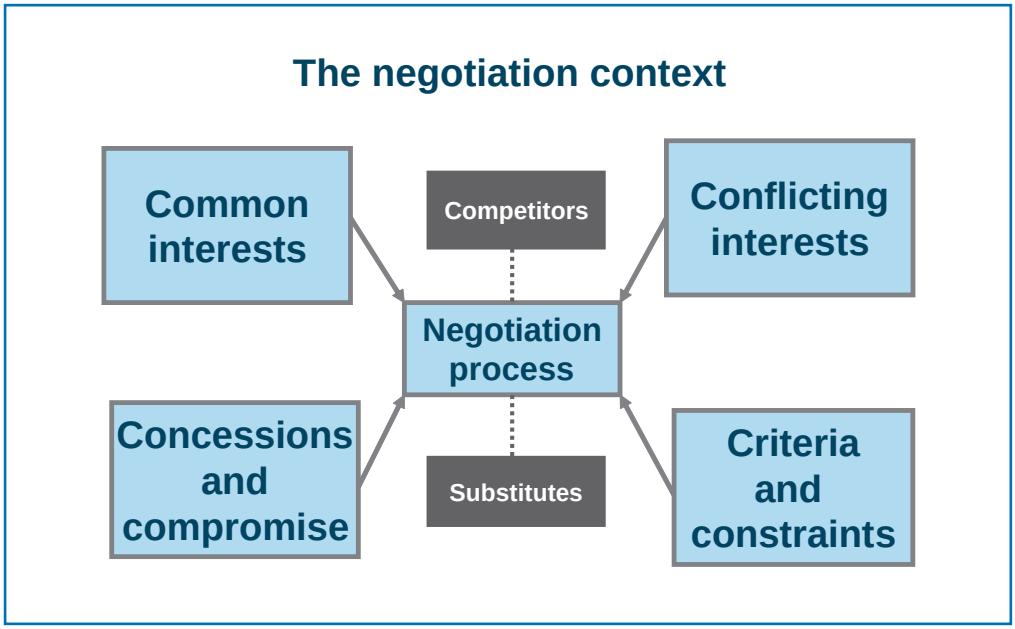
4 International business negotiations

4.1 International business negotiations

4.1.1 Introduction; principles of negotiation

Negotiation is a process by which the parties involved aim at reaching agreement on matters of common interest. The need for negotiating is present in much diversified circumstances, from current situations that happen in day-to-day private life to events that unfold in the international political arena. Every agreement is an expression of the mutuality of interests of the contracting parties; however, the same agreement is also an expression of their conflicting interests, which call for concessions and compromise. Furthermore, there might be criteria and constraints imposed on the negotiating parties as a result of the legal and institutional environment where the agreement is to be implemented; and, when negotiating, each of the parties has to keep in mind the possible existence of competitors for a deal with the other party, as there might be substitutes for what is aimed at in the negotiation. All these elements define the negotiation context, as illustrated in figure 4.1.

Figure 4.1 Elements that shape the negotiation outcome



On the basis of the agreement they make, the parties gain rights and obligations. The measure of these rights and obligations depends to a great extent on the parties, on their knowledge of the subject and on how they set about and implement the negotiation process.

Parties who approach negotiations with a belief that their mutuality of interests will automatically lead to a balanced and satisfactory outcome may sooner or later become deeply and bitterly disappointed. In business negotiations parties position themselves to influence the power balance in their future relationship, and those not skilled enough will get less than they expect and even deserve. Successful negotiators are not born;

rather, negotiating skills and the suitable implementation of a negotiation depend on knowledge and methods that can be acquired through training and refined through experience.

International business negotiations, such as those related to the formation of alliances and joint ventures, are difficult and complex, not only because of the substantive issues involved but also because of the cultural differences between the parties.

Realities and principles of negotiation

- Cultural differences make the negotiation process difficult and complex;
- Each party needs to determine its objectives for concluding a deal;
- Effective negotiations require thorough planning and organization;
- Planning is critical when the parties have unequal negotiation power;
- Each party needs to understand its own parameters and boundaries;
- Negotiations should be conducted in a fair and ethical manner;
- Parties have to listen to each other to understand their respective needs.

Effective negotiations require thorough planning and organization: planning of the desired outcome, its limits and its alternatives; and organization of the negotiation teams, their roles and their compositions. Planning will include obtaining as much information as possible on the other party or parties, which is even more critical in negotiations between parties with unequal power, such as between large and small entities or between parties with significant cultural or language differences. Planning is continuous during the negotiation process. It includes assessment of what is being learned during the negotiation, comparing it with the goals and preparing for the next steps.

Before entering negotiations, each party needs to have a good understanding of its own negotiation parameters: needs vs. wants, acceptable boundaries, and its best alternative to a negotiated agreement (BATNA). Negotiations should be conducted in a fair and ethical manner. An agreement where one of the parties feels wronged is a doomed agreement. Negotiation involves intent and careful listening. Parties have to learn to listen to each other for clues and input on their respective needs. These needs have then to be compared to their own needs and their desired outcome in order to quickly close the negotiation gap.

If negotiations are to culminate in a successful agreement, certain prerequisites must be met before negotiations get under way. Well before an agreement is drafted, each party needs to determine its objectives for concluding a deal. This is an elementary but necessary rule of successful negotiation. Parties often begin negotiations without being clear about the nature and scope of the contractual relationship they wish to establish. This may lead to ambiguity, misunderstanding and even to distrust and bad

faith between the parties as the negotiations proceed. Each party should enter a negotiation with well-conceived and adequately supported goals so that the process moves ahead in an orderly manner.

4.1.2 Negotiation teams

Successful business negotiations should be conducted by a team incorporating the skills that are needed to handle the various specialized tasks and disciplines related to the envisaged agreement. There is a well-accepted view that a negotiation team should be small, with a core of three to five people, and empowered to make decisions. As a general concept, the teams should be composed of the functional representatives with well-defined roles and responsibilities needed to be accomplished, but nothing more. It is better to bring ad hoc external advisors into the negotiations rather than broaden the teams.

Team composition. The team composition will vary according to the situations but, as a rule, it will consist of the chief negotiator, a business expert, a financial expert and a legal expert. If it is a complex deal, engineering, manufacturing and marketing personnel might also need to be involved. Occasionally, an outside consultant will be beneficial. The negotiating team should not be appointed just as formal negotiations are about to begin; it should be given time and opportunity to study the proposed transaction and related back-up information in depth, or to have an input into the positions that the team leader or chief negotiator will present during the negotiations.

Team leader. The team leader's role is a special one. The team leader should be articulate and patient and must have the character and strength to be able to control a meeting and win the respect of his own and the other party's representatives. He must have self-confidence, be able to lead, be able to make decisions when they are needed, and have the support of superiors. He must also be a person who understands the subject, who is broad-minded enough to listen to opinions different from his own and who appreciates arguments and is not offended when someone contradicts him. An understanding of the culture of the other party's country, the language in which the negotiations are to be held, and the culture of the company itself are decisive advantages.

The negotiation team

Team composition. As core team: team leader, business expert, financial expert and legal expert. Possibly later, in addition: engineering, manufacturing and marketing personnel.

Team leader. Must have character and strength, be able to lead and take decisions; should understand the subject and win the respect of his own and of the other party's representatives.

Team discipline. The team leader is the main spokesperson. Other members should speak only when invited by the team leader, having in mind their assigned responsibilities.

Team discipline. A negotiating team should speak with one voice. The team leader is the main spokesperson. Other members should speak only when the team leader invites them to do so, which should be done as frequently as possible to maintain team alertness and spirit. Experienced negotiators make a point of looking for any disagreement between the members of an opposing negotiating team and exploiting it to their advantage, so, obviously, open disagreements between team members must be avoided, as should conveying disagreements by facial expressions and body language.

Team meetings should be held before each negotiating session to go over the points to be discussed and to agree on their handling. Similarly, the team should meet at the end of each session to review the points agreed upon and their general impact on the over-all progress of the negotiations.

4.1.3 Negotiation strategies, tactics and techniques

Negotiation strategies

Once the negotiating team has been appointed, it should start preparing itself for formal negotiations with the other party. This requires focusing on its own and on the other party's key information, objectives and issues; understanding the background and style of the people it is dealing with; and having an awareness of the existence and strength of competitors, the availability of alternative partners, and any other information that may be relevant to defining a strategic approach to the negotiation process.

Negotiation strategies can be classified into two broad categories: competitive strategies and cooperative strategies.

Competitive strategies

In this case, the objective of the negotiating party is to gain as much advantage as possible over the other party through taking forceful positions with a tone of firmness and inflexibility. The likely result of using a competitive strategy is a win-lose situation where the gains achieved by one party will come at the detriment of the other party's interests.

Competitive strategies may be used in situations where there is not enough trust between the negotiating parties, or in cases of one-time transactions, for example supply agreements,

Strategic approaches to negotiation

Competitive strategies: Approached in the manner of achieving a win-lose outcome; used when there is not enough trust between the parties but not suitable for a long-term relationship.

Cooperative strategies: The parties are willing to understand each other and overcome problems through reciprocal concessions; best suited to the negotiation of alliances and joint ventures.

where the main emphasis could be on getting maximum benefit in the short-term; but they are certainly not a suitable way to engage the other party in a long-term relationship.

Cooperative strategies

These are negotiation strategies that aim at mutually beneficial deals and consequently lead to win-win situations. When the negotiating parties follow cooperative strategies, they are more willing to understand each other's positions and try to overcome their problems through reciprocal concessions or creative solutions that result in mutual gain and a sense of satisfaction.

Cooperative strategies are best suited to the negotiation of alliances and joint ventures where relationship-building on a sound basis is an indispensable foundation for the desired long-term cooperation.

In actual practice, negotiators may use a combination of both strategies, for example take the cooperative strategy as the dominant approach but using the competitive strategy when critical interests are at stake or as a way of overcoming deadlocks that may occur during the negotiations.

Other strategic aspects

Negotiation is about achieving envisaged objectives but it is also about concessions and trade-offs to accommodate those objectives with eventually conflicting interests pursued by the negotiating counterparts. In the process of setting the strategic approach that will guide the negotiation process, the parties should recognize, analyze and define positions on a number of aspects such as:

Initial position. Negotiators are not expected to get all they had wished and the bargaining with the other party will likely result in concessions and compromises. Setting the initial position therefore becomes an important strategic issue that should be given careful consideration. A high initial position is recommended in principle because it may positively influence the final agreement; however, it should not be established at unreasonable and unjustifiable levels. Cultural factors may be taken into account in setting the initial position. In some cultures, bargaining is regarded as a natural part of making business, and high initial positions are favoured. In other cultures, there is little propensity to bargain, and the negotiators should therefore set their initial position close to what they are prepared to accept.

Best alternative to a negotiated agreement (BATNA). One of the most important strategic methods to apply is the use of alternatives. In other words, the negotiator has to know in advance his or her best alternative to a negotiated solution. This is the next best outcome in the event that both sides fail to reach an agreement. The "best alternative" to a negotiated solution is definitely not a bottom line. Unlike the latter it protects the negotiator from accepting terms that are too unfavourable and, on the other hand, from rejecting terms which would be in his or her interest to accept. If the negotiated agreement is better than BATNA it would probably be wise to accept it; if not, it would be advantageous to walk away from the negotiations and take the alternative.

Elements of negotiation strategy

Initial position:	In principle, should be high but not unrealistic
Best alternative:	Use as a reference against unfavourable terms
Sequence vs. issues:	Way of building confidence and progressing
Setting limits:	There is a preferred point but an acceptable range
Making concessions:	Practically inevitable and eventually useful
Preparing arguments:	Defend positions and minimize concessions

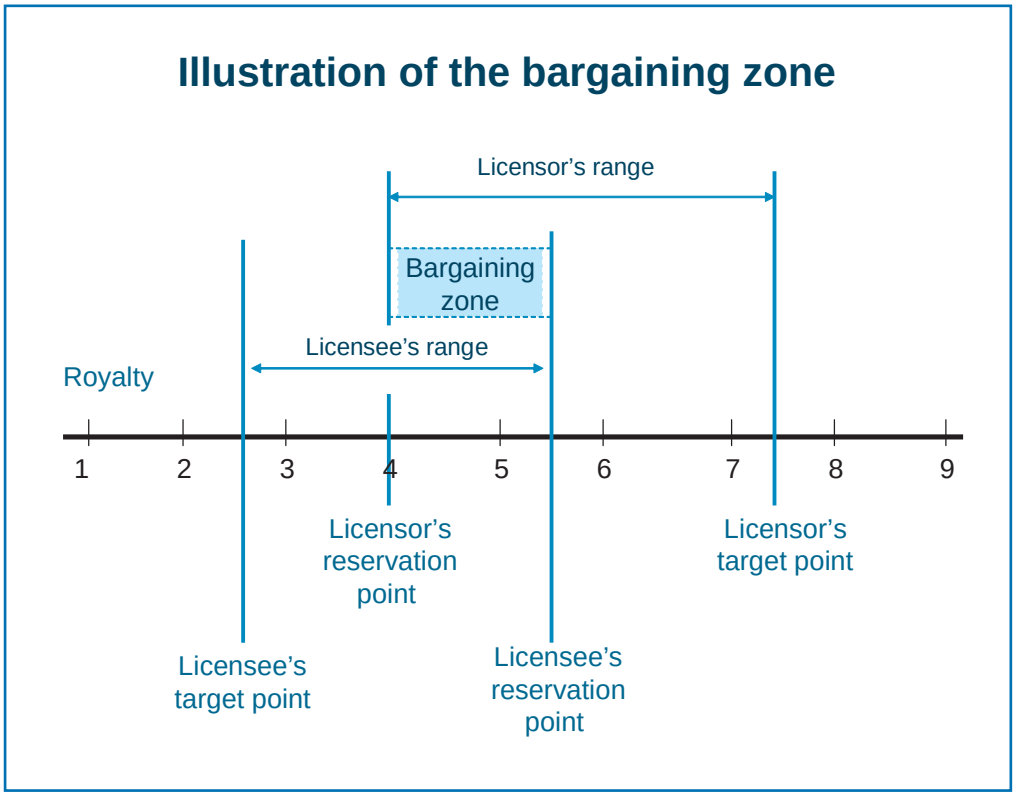
Sequence versus issues. While the agenda should establish the list of issues to be discussed and agreed upon, the path of the negotiation must not follow the registered order. Some negotiators prefer the use of issue planning, which consists of discussing issues independently and using logic and intuition to tackle difficult problems, and not following a predetermined sequence. For example, it could be more effective to start by tackling issues more likely to be agreed upon without difficulty. This contributes to building acquaintanceship and confidence between the parties, creating a positive atmosphere for the ensuing negotiations, and making it easier to reach agreement on more difficult and complex issues that may preferably be negotiated at a later stage.

Setting limits; the bargaining zone. Each party has a certain target in mind, or most preferred point, which is the ideal result he or she would like to arrive at. For example (*see* figure 4.2), a technology licensor would aim at a high royalty while the licensee would wish to have it at the minimum possible level. Also, each party has a certain reservation point below which (for the licensor) or above which (for the licensee) there is no interest in making a deal because there might be better alternatives available. The deal is only possible if the negotiation ranges of each party overlap to some extent thus providing for a bargaining zone. The problem for negotiators is to achieve a result as close as possible to their most preferred point, which also means a good perception of the other party's reservation point.

Making concessions. Making concessions is practically inevitable in the negotiation process, and the parties should plan in advance the concessions to be made, their extent and cost, and also the timing and the manner in which they are presented. Concessions are helpful in creating a sense of cooperation, overcoming impasses and allowing for the advance of the negotiation process; but, as a rule, they should be calibrated, used with caution, and accompanied by reciprocal moves by the other party. Skilful negotiators are able to make small concessions and give the other party the good feeling of achieving an important gain. In principle, smaller concessions are made at the initial phase of the negotiations and major concessions are left to the final stage; but, as is the case with other strategic aspects, this also depends on cultural and contextual factors.

Preparing suitable arguments. A negotiation is a process of interaction between people who may be starting with initial positions that are far apart. In order to strengthen their bargaining position, minimize concessions and remain as close as possible to the targets established, the parties should make a careful preparation, including the gathering of information and the development of arguments that could support the proposed terms and positions, should anticipate the other party's own positions and should think of

Figure 4.2 Setting limits for the negotiation



what counterarguments could be persuasive and lead to acceptance. It would be helpful to get access to people who have been involved in previous similar negotiations and get advice on what arguments they have found more effective in affirming positions and producing meaningful concessions.

In the context of establishing alliances and joint ventures, negotiations should be carried out in a spirit of relationship building, i.e., in finding similarities, common interest and trust in each other, as only these ingredients create mutually beneficial solutions.

Negotiation tactics

No description of the negotiating process would be adequate without at least a brief overview of negotiation tactics. A substantial body of knowledge and literature has accumulated over the years in this field, stretching from sophisticated psychological treatises to cookbook type recipes on how to apply "tricks" to exert pressure on the other side. While the techniques listed above are considered legitimate bargaining tools in an effective negotiating process, the use of tactical manoeuvring, especially in establishing alliances and joint ventures, is questionable. In these cases, the building of trust, common interests and interpersonal relationships play the predominant role and not the adversarial approach.

However, negotiating tactics need to be listed, if only to make the inexperienced negotiator aware that, to a certain degree, verbal and non-verbal tactics are always present in negotiating, as they are made up of a combination of promises, hidden or not so hidden threats, recommendations, rewards and commitments, and have often been developed into a fine art of so called "dirty tricks". A sample of these tricks includes:

Bad guy/good guy. This presents a "bad guy", who does not want to yield on any issue and who proposes unacceptable demands, and a "good guy", who makes reasonable proposals and acts in a moderate way. Actually, the "reasonable" proposals of the "good guy" may also be unreasonable.

Divide and conquer. In this ploy, one opposing member whose views appear more acceptable than those of the opposing team leader is selected and then played up to and treated as a reasonable person. The aim is to provoke a division in the opposing ranks.

Trial balloon, red herring, straw man. All of these are variations of the same tactic; arguments may be presented not because they are meaningful or believed but simply to obtain information, or to instil a false sense of confidence in the other party.

Examples of negotiation tactics

Bad guy/good guy:	Actually, the good guy may not be that good
Divide and conquer:	Ploy to provoke divisions in the opposing team
Trial balloon:	Deceit by instilling false sense of confidence
Threatening a walk out:	Can be effective but has to be used with care
Last minute demands:	Used under belief that they may be irresistible
Standard terms:	Powerful tactic; but everything is negotiable

The following three tactics also have a legitimate use in negotiation to try to break logjams or to resolve difficult issues but should be presented as such, with transparency and in earnest.

Threatening a walk-out. Threatening to terminate the negotiations is a tactic often used to gain an important concession. It can be successful if it appears the other party is under pressure to obtain the agreement being negotiated. This tactic needs to be used very judiciously and only when the issue is so crucial that the party making the threat will not hesitate, if the point is not conceded, to carry it out.

Last minute demands. Last minute demands are generally made after negotiations have been completed and the negotiators are under the impression that they now have completed their work. The tactic is used in the belief that the pressure to accede to such a demand may be irresistible.

Standard terms, national practice. This is a tactic commonly used to obtain favourable terms by presenting them as standard conditions or required by national law or practice.

This tactic is sometimes powerful, particularly if it can be independently verified, in which case it is difficult to counter. In any case, negotiators should consider that practically everything is negotiable.

Negotiation techniques

While the negotiation strategies are developed as long-range methods intended to advance the general resolution of issues and implement the negotiation as a whole in a satisfactory manner, the negotiation techniques are designed to obtain agreement from the other party on specific problems that may arise as the negotiation unfolds.

The list below presents various negotiation techniques that are often used to speed up agreements or to overcome impasses or breakdowns in negotiations:

Deferring difficult issues. Experience shows that agreement, like success, creates momentum and an atmosphere which induces negotiators to seek ways and means to reach agreement on other, more difficult issues as well. A useful technique for advancing the process of reaching agreement is to defer issues that appear most difficult to resolve and tackle those that can be set quickly.

Taking up general propositions before specific ones. This is related to the one above, as it is often far easier to agree on a general proposition than on a specific one. Similarly, agreement on principle is often more easily obtainable than on a specific language that applies the principle to the appropriate facet of the transaction.

Using committees to resolve difficult issues. Certain issues may prove difficult to resolve and might require exploration of alternative solutions. Formal negotiating sessions may not be the best setting for exploring possible solutions. It may sometimes be more effective to set up a special task force of negotiators or experts to explore the different solutions and report back to the negotiating teams for decision-making.

Keeping score of concessions. Skilful negotiators will keep a summary record of the issues on which concessions have been made. This constitutes a "pool of credit" which can later be called upon to obtain concessions from the other side on issues which may be unrelated to the concessions made earlier.

Examples of negotiation techniques

Deferring difficult issues:	A useful technique for advancing the process
General before specific:	Taking up general issues before specific ones
Using committees:	A committee may be useful for difficult issues
Concessions and quid pro quos:	One concession for another breaks impasses
"Two-way" street argument:	This makes objectionable proposals palatable
Peeling the onion:	Breaking down the issues into various layers

Offering quid pro quos. Another simple and frequently used technique is the quid pro quo, which is one concession for another or one set of concessions for another set. All of these techniques are essentially designed to break an impasse by balancing concessions on each side.

Using the "two-way" street argument. Proposals are often advanced which may be difficult to oppose because, on the face of it, they appear reasonable although they may have objectionable long-term implications. One technique to accommodate such proposals is to agree to them provided the other party agrees to the inclusion of equivalent conditions.

Peeling the onion. Negotiators are occasionally faced with issues whose solution requires a concession by the other party of such magnitude that it seems unlikely to be obtained. The technique often used in such cases is to break down the issue into its various layers and resolve it topic after topic.

4.1.4 The negotiation phases

There is no best way to negotiate and no guaranteed formula for success. While a negotiation should be well prepared in advance, the actual development of the process has much to do with human factors and how they come into play throughout the interaction between the negotiating parties. However, experience shows that four different phases can roughly be distinguished in the negotiation process.

Phase (1) Interpersonal relationship building
This is the phase at the outset of the negotiation sessions during which individuals on both teams develop respect and trust for the members of the other side. It is also a stage during which they discover areas of similarities and differences in both their relationship and the substance of their discussions. A strategy of "separating people from the issues and problems" implies that negotiators can reject the other side's suggestions without rejecting the people on the opposite team. In other words, they can enjoy and trust their opponents as individuals while rejecting their proposals. It is important that the interpersonal relationship is built on this foundation during this "getting to know" period because, in the final analysis, people keep commitments to people and not to contracts.

Phase (2) Exchange of issue-related information
The substance of negotiations lies in "seeking common interests". Negotiations should therefore focus on presenting situations, issues and needs and on understanding their partner's own situation and needs. This is not the same as stating a position, which could lead to an impasse if the other side find such a position unacceptable. If, on the other hand, a given situation and the needs felt are presented in such a way that the other side feels inclined to offer various partial solutions, the demand could be possibly met at the end. In any case, it cannot be over-emphasized that negotiations should draw on the widest possible range of mutually agreeable solutions. To understand this point fully, it helps to practice "role reversal" in preparing for the actual negotiations.

Phase (3) Persuasion
When cooperative strategies prevail, negotiators emphasize the creation of synergies and the building of mutually beneficial options, either on similar interests or on the

acknowledgement of their cultural differences, while in traditional negotiations the parties emphasize persuading the other side. In successful negotiations both parties' interests and needs are recognized and both parties win. Mutually beneficial options derive, therefore, from:

- understanding both parties' real interests, values and needs;
- identifying areas of similarity and/or differences;
- creating new options based primarily on the differences between the parties.

Phase (4) Making concessions and agreements
These can be made at any time during the negotiations, but it appears that those who make them early put themselves at a disadvantage in comparison to those making fewer concessions and primarily at the end of the meeting.

In conclusion, experience has shown that effective negotiators approach each of the negotiation phases listed above through predetermined strategies, that is:

- to build interpersonal relationships, which separate the people from the problems;
- to exchange issue-related information, which focuses on interests and needs but not on positions;
- to effectively persuade the other team by highlighting options for mutual gain rather than relying on preconceived positions and high pressure tactics;
- to make appropriate concessions and to reach agreements which insist on using objective criteria rather than on giving in to pressure.

4.1.5 Cross-cultural considerations

Cross-cultural negotiations are often difficult to conduct. On top of the normal obstacles, the relationship building is made more difficult by differences in nationality, culture, race, gender and language. Similar difficulties may occur in negotiations between two entities of vastly different corporate culture, such as between universities and large corporations or between small and large entities. In any of these cases, special care should be taken to understand how the parties expect the negotiation process to evolve and prepare for it accordingly.

When more than one language is used or when participants have an unequal knowledge of the negotiation language, extra time and care is needed. Use of translators should be carefully controlled. Their role has to be restricted to translating. Each party should hire their own translator. Translators and negotiators should be instructed to take "small bites". Nothing is more frustrating to the teams than to listen to a lengthy dissertation and then hear it translated in a few sentences.

Even in dealing with persons of the same cultural background, it is difficult to have a clear understanding of their intentions and proposals, and, when backgrounds differ, the problems are compounded. It is, therefore, essential for negotiators to learn as much as possible prior to the meetings about the foreign culture, the foreign negotiating partners and, if possible, their negotiating styles. It is also critical to frequently replay or paraphrase what was said to make sure it was understood correctly. Always avoid use of colloquialisms that cannot be easily translated or understood.

4.1.6 Rules of negotiation conduct

Negotiating styles differ widely, especially in international settings, and everyone develops her or his own personal style over time and as experience grows, but there are four principle rules of conduct that all negotiators should adhere to; these are:

(a) Presentations should be made calmly and without personalizing. Under the motto of "separating people from issues and problems", it would be counterproductive to become emotional or even angry during negotiations. Such conduct would diminish the chances of eventually creating mutual understanding and trust.

(b) Statements should be fully explained and supported by logical arguments. The ability to present logical arguments in support of a position is the mark of a successful negotiator.

(c) Unreasonable or arbitrary demands, as well as ultimatums, should be avoided. Should these be imposed by a higher authority, the negotiator should attempt to correct this attitude at the source as it would undermine his credibility and effectiveness, at least when negotiating a joint venture.

(d) The validity of the other side's arguments and concerns should be admitted when appropriate. As repeatedly mentioned, the aim of negotiating joint ventures lies in "seeking common interests". It is therefore reasonable to concede the validity of logical arguments by the other side when they are justified.

Rules of negotiation conduct

- Separate people from issues and problems
- Be logical and explain positions and claims
- Avoid unreasonable and arbitrary demands
- Admit the validity of the other party's arguments

Review of chapter 4.1

International business negotiations

The context of the negotiation involves both the common interests of the parties and the conflicting interests which call for concessions and compromise. Furthermore, the negotiators may have to abide by criteria and constraints external to their specific interests, and should keep in mind that the other party may have competing offers or other options to a deal.

Successful negotiators are not born; rather, negotiating skills and the suitable implementation of a negotiation depend on knowledge and methods that can be acquired through training and refined through experience.

Effective negotiations require thorough planning and organization: planning of the desired outcome, its limits and its alternatives; organization of the negotiation teams, their roles and their compositions. Planning is continuous during the negotiation process. It includes assessing what is being learned during the negotiation, comparing it with the goals and preparing for the next steps.

As a general rule, the negotiation team should be composed of the functional representatives with well-defined roles and responsibilities needed to be accomplished, but nothing more. It is better to bring ad hoc external advisors into the negotiations rather than broaden the teams.

The strategic approaches to the negotiation process can be competitive—when a win-lose outcome is envisaged—or cooperative—when problems are overcome through mutual concessions. These latter are best suited to the negotiation of alliances and joint ventures.

The main elements of a negotiation strategy are:

(a) initial position: in principle, should be high but nor unrealistic;
(b) best alternative, to use as a reference against unfavourable terms;
(c) sequence vs. issues: a way of building confidence and progressing;
(d) setting limits: i.e. the preferred point but also the acceptable range;
(e) making concessions: practically inevitable and eventually useful; and
(f) preparing arguments to defend positions and minimize concessions.

Negotiation tactics may be regarded as legitimate tools in the negotiation process, but they could become questionable when used in the negotiation of alliances and joint ventures, where the notions of trust, confidence and common interests should be dominant.

While the negotiation strategies are developed as long-range methods to implement the negotiation as a whole in a satisfactory manner, the negotiation techniques are designed to obtain agreement from the other party on specific problems that may arise as the negotiation unfolds.

Cross-cultural negotiations are more often difficult to conduct. It is, therefore, essential for negotiators to learn as much as possible prior to the meetings about the foreign culture, the foreign negotiating partners and, if possible, their negotiating styles.

Negotiation styles differ widely, but there are rules of negotiation conduct that are important in all circumstances. For example:

(a) presentations should be made calmly and without personalizing;
(b) statements and claims should be supported by logical arguments;
(c) unreasonable demands should be avoided; and
(d) the validity of the other side's arguments should be admitted.

4.2 Contracts and contract drafting

4.2.1 General considerations

Once the technical and economic studies have demonstrated that the project is viable and discussions between the parties have shown that there is a good basis to arrive at a solid and durable business relationship, it is time to move to the negotiation phase and translate the agreement arrived at into a formal contract.

The following sections are aimed at:

(a) highlighting the importance of having a formal written document setting out precisely and clearly the rights and obligations assigned to the parties;
(b) explaining what a contract is as a legal instrument and highlighting its main characteristics of correctness, clarity, homogeneity and originality;
(c) elaborating on the possible approaches to structuring a contract and presenting the elements and clauses that are common to practically all contracts;
(d) recalling the good practices that should apply to the drafting of contracts, the need for team work in the drafting process, and the role and limitations of model contracts;
(e) introducing the main legal systems in the market economies—common law system and civil law system—and elucidating how they reflect on the drafting of contracts.

This is intended to bring to the users of this training package an awareness of what a contract is and, at the same time, to provide an overview of the basic principles that should guide the drafting of contracts. The issues and the principles enumerated in this chapter are of common interest and relevance to all contracts—therefore they cannot but be useful to those in charge of drafting joint venture agreements and other agreements associated to them, for example agreements related to the supply of technology and provision of services to the joint venture company by one or both partners (*see also* chapter 3.5).

4.2.2 The importance of a written document

The parties to a joint venture agreement should only embark on the deal and sign a contract after a process of mutual acquaintanceship, confidence building and clarification of all aspects related to their expectations and legitimate interests. There are people who say that a good contract is the one that you sign, close in a drawer and don't need to look at ever again. This means that the parties fully understand the purpose of the contract and what they have negotiated, have done it in good faith and, above all, are committed to implementing it without any reservation or feeling that they need to stick to the wording of the document. This is what is called keeping to the "spirit of the contract".

Why then is a written document needed? There are several reasons: a joint venture agreement may involve many and complex issues of a technical, economic and legal nature; the implementation of the agreement may have to involve other parties (government agencies, financial institutions, suppliers of equipments, subcontractors, etc.); hence a written contract is indispensable to ensure that everybody has the same understanding

of the deal; and during the contract life problems may occur requiring court litigation and interpretation of what has been negotiated, in which case the problems can only be settled on the basis of what has been written in the contract. A written document formulated with clarity, conciseness and precision has a further advantage in the case of a long-term agreement since the persons dealing with it on both sides may change. A clear, well-phrased text will prevent newcomers from interpreting the contract differently than initially intended.

4.2.3 Contracts: meaning and characteristics

The meaning of a contract

A contract is a legally binding agreement between two or more parties creating both an obligation to do or refrain from doing something, and assigning a corresponding right. For example, in a licensing agreement the licensee has the right to use the technology and the obligation of paying a certain amount for it; and the licensor has the obligation to provide the necessary technical elements to the licensee and the right to receive a certain payment; or the licensee is required to refrain from disclosing the technology to third parties or from exporting the products to certain markets, and so on.

The purpose of a contract

The purpose of a contract is to set out the understanding arrived at by the parties after negotiations, and to provide for the enforceability of its understanding in a court of law.

A contract usually addresses itself to three main issues:

- the subject-matter of the agreement
- the business interests of the parties
- legal-administrative provisions

A contract generally emerges after several preceding activities have taken place, such as:

(a) positive assessment of the viability of the underlying project based on the pre-feasibility and feasibility study;
(b) exploratory contacts between the prospective partners, collection of information and confidence-building;
(c) conducting of face-to-face negotiations leading to an agreement on the terms of cooperation;
(d) preparation and submission of a draft contract by the party specifically assigned to do so during negotiations;
(e) review of the draft by the receiving party from the point of view of its self-interest, and possible presentation of counter-proposals;
(f) indication of acceptability by the party preparing the primary draft, with face-to-face renegotiation sometimes required;

The characteristics of a contract

Clarity, precision and conciseness

A contract should spell out as clearly, precisely and concisely as possible the identity of the parties, its subject(s), the granting of rights and their limitations, the scope and contributions of each party, the consequences of possible defects or failures, and the effects of termination or expiration of rights and obligations. The contract should not leave room for alternative interpretations.

The characteristics of a contract

Clarity, precision and conciseness: a good contract should not leave room for alternative interpretations;

Correctness, fairness and balance: satisfaction of both parties is important for a long-term relationship;

Homogeneity and completeness: the clauses should be consistent with each other and form a complete set;

Originality and uniqueness: each contract is tailored to a certain project, thus it is unique and irreproducible.

Correctness, fairness and balance

A contract should correctly present the basic interests and expectations of the parties and exhibit fairness and balance in the rights, obligations and expectations asserted. It is not good for a long-term relationship that one of the parties becomes frustrated with imbalances and feels a loser.

Homogeneity and completeness

A contract is not simply a loose collection of clauses; the clauses of a contract are interrelated and consistent with each other, forming a system where any action taken to modify one element will also have an effect on other elements. A good contract will also have to be a complete contract in the sense that, should the parties discharge their obligations as set forth in the contract, the undertaking to which the contract applies will prove successful and will meet the expectations of the parties.

Originality and uniqueness

Each contract is unique and irreproducible. It results from a particular set of circumstances, which are specific to the parties involved and intrinsic to a specific negotiation process with its own path, and from the creative thinking and compromises which are needed to overcome conflicting interests and diverging positions. A suitable contract has to be tailored to the project in question.

4.2.4 Model contracts: role and limitations

Business-related associations and international organizations, including UNIDO, have developed model forms of contracts intended to fit the drafting needs of negotiators for certain categories of contracts or specific sectors, for example patent licensing contracts, engineering services contracts, turnkey contracts for fertilizer plants, and so on. Model forms are useful, and they usually reflect a lot of effort invested in their preparation. Their structure and content represents an important guiding tool, not only in their checklist of clauses but also in their content and drafting. However, they should be used with caution; it would be naïve to think that, if a party to a contract is unprepared to negotiate and draft a contract, it can solve its problems by using a model form of contract because, as pointed out above, each contract relates to a very particular set of circumstances, and model forms (which, by their nature, relate to general and abstract situations) always require substantial modifications, both in the structure of the agreement and in the wording of the clauses, which can only be done by an experienced professional.

4.2.5 Who should draft the contract?

The foreign partner or the local partner? This question is pertinent because the contract will generally tilt in favour of the drafting party. In many cases of joint ventures between foreign investors and developing country partners, it is the foreign investor who submits his draft to the local company.

As a rule, foreign investors are well-experienced in drafting techniques, and the initiative rests on them of proposing the conditions they envisage for the transaction. But it need not be so. An assertive developing country partner can also take the initiative of submitting its draft to the prospective foreign partner and reflect in it conditions which are to its convenience. Whatever approach, the parties should keep in mind that the first draft contract submitted by one party is not to be blindly accepted by the other; it should be regarded as a step in a negotiation process whereby different interests and conflicting positions are exposed, discussed, and subjected to give and take so that the gaps are narrowed and mutually acceptable solutions are reached.

One person or a team? Another aspect is that the formation of a joint venture involves considerations of a technical, economic, financial and legal nature, and in many cases the issues to be dealt with are rather complex and call for a multidisciplinary effort. Consequently, the drafting of a contract is best carried out by a team of personnel with professional experience in the various relevant areas. Also, having in mind that the contract is a legal instrument to be interpreted and implemented within the framework of a legal system, the participation of a lawyer in the drafting of the contract is almost indispensable, even if only to review the final draft in order to ensure its consistency with basic principles of law. By the same token and because a joint venture agreement involves complex technical matters, the draft should not be the product of the lawyer's work alone, as some people think it could be.

4.2.6 Anticipating problems: what could go wrong?

In an ideal world, the parties to an agreement have a common and clear understanding of the business relationship they have established and expect that the joint

undertaking will be implemented as smoothly as possible through the planned life of the contact. The realities of the business world, however, may confront them with many problems, from mere annoyances that can easily be overcome through amicable resolution to worst cases that may require drastic remedies, including resort to the court of law. One of the most useful habits a drafter should have is to continuously ask and seek to answer the question "What could go wrong?". The draft team's task in this connection is to project scenarios and try to identify potential problems in the short, medium and long term, and provide contingency plans for anything that could go wrong.

What could go wrong?

Answering questions such as the following will considerably improve the draft and facilitate its implementation:

- What if the market conditions change dramatically?
- What if one of the parties ceases to fulfil its obligations?
- What if one of the parties is taken over by a competitor?
- What if the patents to be used are declared invalid?
- What if competitors come up with a better technology?
- What if the licensor grants the licence to a competitor?
- What if a third party infringes assigned licence rights?
- What if one of the parties gets out of the agreement?

The list could go on and on with many other questions, depending on what the contract is about and on the characteristics of the scenario within which it is to be implemented. The contract should be drafted in language and terms that explicitly cover possible changes and the most adverse turns of events and should anticipate appropriate remedies.

4.2.7 Contract drafting and legal systems

From an international business perspective, there are two main legal systems, namely the common law system and the civil law system. When deciding on the structure of a contract and its wording, the drafters should keep in mind whether the contract is to be governed, and eventual disputes settled, under a common law system or a civil law system.

Common law system

The common law, also called Anglo-American law, is the system prevailing in the United States, the United Kingdom and in many other English-speaking countries. Common law goes back to ancient kings who used to make legal decisions on a case by case basis; it is a system based on tradition, precedent, and custom and usage. The courts play an

important role by interpreting events in line with earlier decisions in similar cases, the so-called precedents. For this reason, the common law is also called case law.

Legal systems: common law and civil law

Common law systems

Origin: Anglo-American law, also called case law. Court interpretations and decisions mostly based on precedents. In common law, contracts tend to be detailed.

Civil law systems

Origin: Roman law, also called continental law. Most contractual aspects are detailed in the civil codes. In civil law, contracts usually have a simpler structure.

In a common law system, the contracts tend to be detailed, covering all anticipated problems and envisaged solutions so that, in the event of litigation, the court would arrive at an undisputable solution whatever the precedent used. As an example: if a judge once refused damages because the plaintiff had incurred "costs" while the contract spoke only of "expenses", future contracts will tend to speak of "costs and expenses" thus avoiding the problem of interpretation.

Civil law system

A civil law system is based on a detailed set of laws that make up a code which establishes what is legal or not, especially in contracting and commercial transactions. With regard to business transactions, in a civil law system the contracts negotiated and entered into by the parties tend to be shorter and less detailed than those in a common law system because most of the contractual aspects and related implications are contemplated in the civil code. By the same token, civil law tends to be less adversarial than common law.

The civil law is also called continental law because it prevails in most of continental Europe, for example, in France and Germany. It derives from a code developed by the Roman Emperor Justinian and has influenced many legal systems around the world. Over 70 countries, including Japan and most South American countries, operate on a civil law basis.

4.2.8 Form and structure of contracts

General structure

Although it is assumed and customary that a contract has a certain form of organization and a certain wording of its terms and clauses, it is not essential to abide by a pre-determined format when drafting and formulating the deal arrived at by the parties. A particular agreement can be translated into a contract in many different ways.

Even an exchange of letters and other documents, like the proceedings of meetings, can constitute a contract; and a formal contract can be shorter or longer, as much as is deemed necessary; sometimes the contract is supplemented by annexes intended to express technical details or to clarify relevant issues; and these annexes, which are identified in the concerned clauses, themselves become part of the contract. What is important is that such written elements reflect the agreement reached by the parties in a way that the commitments taken are clearly understood and can be enforced in a court of law.

Highlights of the structure of contracts

A contract need not have a pre-determined format, and a particular agreement can be formulated in different ways;

Contracts for different purposes focus on different issues and require different sets of conditions and clauses;

There are elements common to all contracts, such as the identification of the parties, indication of purpose, etc.

For the purposes of this training package, different types of contracts are considered here. First and foremost, we have the joint venture agreement; but the formation and functioning of a joint venture entails the negotiation and implementation of other agreements, for example those related to the licensing of technology, engineering services, technical assistance, managerial services, and the supply of other needed inputs. While, as highlighted above, a contract related to a particular deal can be structured in different forms, each type of contract has a particular purpose and focus requiring its own set of clauses, which differ from one type of contract to another. Naturally, the structure of a joint venture agreement will concentrate on the objectives of the joint venture company, the composition of ownership and capital structure, the contributions and inputs from each of the partners, and the allocation of managerial responsibilities. A licensing agreement (where issues related to the validity and proprietary nature of the technology are dominant) must have a totally different configuration and is itself different from an engineering services agreement (where issues of design, delivery times and performance guarantees are critical).

The common elements and clauses

While each type of contract shows a different structure and contains a specific set of clauses, there are elements and clauses that are common to all contracts. In general, all agreements spell out the following:

- the exact identity of the parties
- the subject matter of the contract
- the obligations of each party
- the obligations common to the parties
- the legal-administrative provisions

The above elements are embodied in the following clauses that all contracts should, in principle, contain:

Identification of the parties

This is usually the opening paragraph of the contract: it should identify the parties to the agreement with their official names, addresses and, when applicable, the location of their governing law of incorporation.

Purpose

The purpose of an agreement should be stated in a paragraph that captures the essence of why the licence agreement is being executed. A statement can also be made, either in this section or in the "whereas clauses", on the economic aim of the contract.

Effective date of the agreement

This is the date when the agreement comes into full force and effect; the effective date is not necessarily the date of the agreement, which is the date when the agreement has been signed by the parties.

Whereas clauses (recitals, preamble)

These clauses contain such things as licensor and licensee representation and the background of the agreement; they may be useful for understanding and interpreting the agreement, for example in the case of litigation.

Definitions

To preclude misunderstandings between the parties, the subject matter and keywords that will have a broad impact in the agreement and may have different interpretations, should be clearly and unambiguously defined. This section on definitions should include as many terms and keywords as are deemed necessary.

Term or duration of agreement

All agreements should stipulate a term, i.e. the period of time during which the parties' obligations are in force. For a patent licensing agreement, the duration should correspond to the validity of the patent. In some cases, for example know-how licensing or trademark licensing, the contract may have a provision that foresees its extension or renewal, if both parties so wish.

Termination of the agreement

The parties should anticipate the situations where there will be reasons to terminate the agreement (end the contractual relationship before its normal term) and should make provision for the settlement of related issues such as overdue payments, compensation for damages, non-use of proprietary machinery and trade secrets, etc.

Best efforts

This kind of clause states that, with respect to a certain envisaged purpose or target, the concerned party will use its best efforts to pursue such purpose or achieve such target. This is used when there is a certain purpose or aim in the contract but the obligated party is not in a position to make, or does not wish to make a binding commitment.

Applicable law

This aspect takes on a very high relevance if problems occur requiring settlement by a court of law. The applicable law need not be the national law of the licensor's country or the licensee's country. It can be any law agreed upon by the parties on the basis of their understanding of how such law interprets and regulates the terms of the agreement.

Arbitration and conciliation

In the event of litigation and disputes, the parties may wish (and they should) resolve their problems amicably before resorting to the court, which is always a lengthy, costly and hazardous proceeding. They should therefore make the necessary contractual provisions related to the conciliation and arbitration rules and procedures they wish to follow.

Assignment; change of control

The contract is signed by two parties that know and trust each other. What then, if one of them is taken over by or merges with a third party? It is important for the agreement to provide for assignment or preclude it. The parties should ensure that there is no undue restriction to their rights in the contract in the event of new owners; they should take care that their know-how and assets do not fall into competitors' hands.

Entire agreement

Because there might be many documents produced during negotiations, there should be a clause stating that the licensing agreement currently being consummated represents the entire agreement between the parties on the subject matter and supersedes all previous agreements or understandings between them on the subject matter.

Force majeure

This clause provides that neither party to the agreement will be responsible for failure or delay in performing their obligations due to circumstances beyond their control, for example acts of God (flood, stormed, earthquake), explosions, major accidents, war, terrorism, labour disputes, and so on. The listing of force majeure circumstances should be discussed, though.

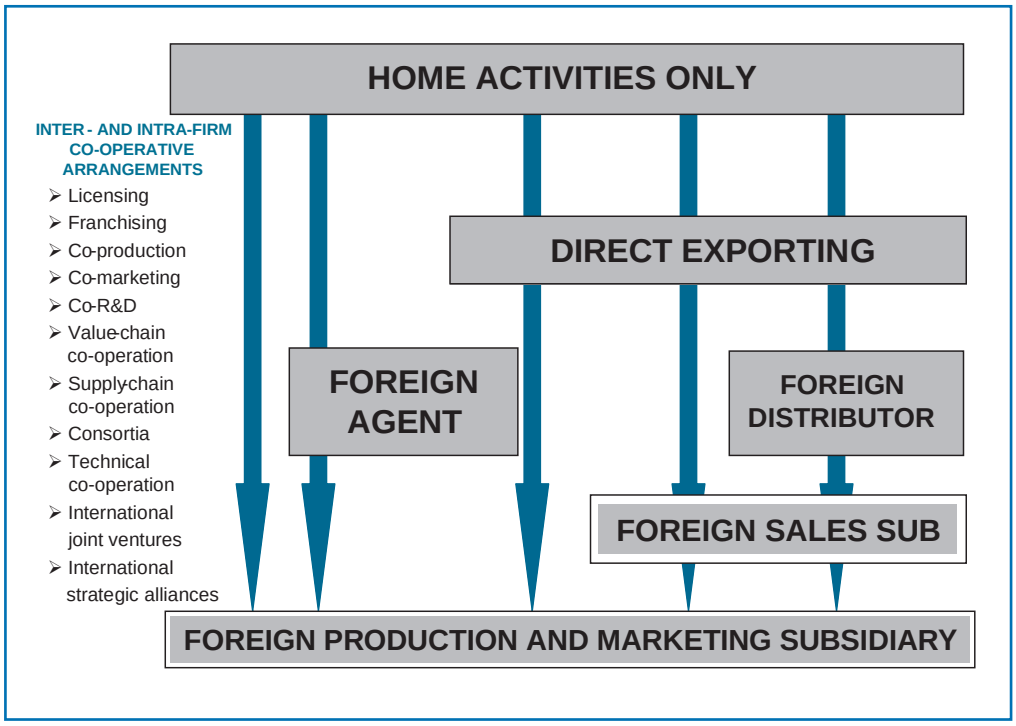
Notices

The parties will designate the principal contacts and mechanisms for their contacts related to the implementation of the contract, including the designation of key contract persons and rules for their handling of correspondence, telephone calls, notices, royalty payments, technical assistance, patent administration, etc. The language of communication should also be stated.

Alliance capitalism[69]

This term was created to designate the multifaceted pattern of FDI operations involving simultaneous collaboration with competitors and rivalry (in different economic spaces) with strategic and alliance partners, as well as participation in dense networks of technology suppliers. In practice, this means that the former patterns of FDI, with more predictable modes of market entry in sequential time and place, have been replaced by parallel modes of market of entry and servicing through intricate systems of industrial sourcing, technology, production, marketing and servicing, which involve offshoring and outsourcing modalities of joint ventures, strategic alliances, co-production and marketing, co-R&D, contract design and manufacturing with equity and non-cooperative arrangements. This reality is illustrated in the diagram, which can be seen more vividly in the accompanying set of visuals.

Parallel modes of FDI and SOO entry in international patterns of "alliance capitalism"



Back office

Back office is the part of the company which implements the tasks related to the running of the company itself, for example the overall ITC functions, such as the running of telephones and computers, information processing, human resources management, invoicing and accounting, database maintenance, recording sales and purchases, reporting, etc. The back office operations are distinct from front office functions, i.e. those involving interaction with customers, as in sales and marketing.

[69]Dunning, J. H., 1977 (*source:* Bartels, 2005 and Buckley, 2003).

Back offices are sometimes moved away from the company's headquarters, for example to suburban locations where rents and other costs may be cheaper; and, in many cases, they are moved to developing countries, either through FDI (fully-owned subsidiary, joint venture) or through outsourcing, in order to take advantage of available skilled manpower at lower costs.

The term "Business Process Outsourcing" (BPO) is used in connection with the above to designate those situations where the management and implementation of one or more business processes, or the whole set of business functions, are subcontracted from an external supplier.

Best efforts

The so-called "best effort clauses" are included in contracts with the purpose of addressing situations where one of the parties expects the other party to fulfill a certain requirement but that party does not feel in a position to take a clear-cut binding commitment in that regard and, instead, promises to undertake their best efforts to fulfill what is expected, for example to achieve a certain volume of sales or provide a certain input or service at a specified point in time.

The parties should take special care in the negotiation and drafting of best effort clauses and should agree on what may constitute best efforts in terms of specific steps to be taken by the party liable for the undertaking. This is important in order to ascertain, in the event of dispute over non-fulfilment, whether the party in default had really and reasonably expended all the expected efforts within its reach, or was simply negligent, not putting enough effort into fulfilling a clause regarded as non-binding, or, possibly, never having had a serious intention to fulfill it.

BPO—Business Process Outsourcing (*see* "Back office")

Buyer-driven value chains (*see also* "Producer-driven value chains")

In this kind of value chain, large buyers with core competencies in branding and marketing are the driving actors in setting up the chains. They organise, coordinate and control production, designing and marketing activities to target consumer markets in developed and developing countries and in the transition economies. These chains are typical for labour-intensive industries and are highly relevant to developing countries (for instance, agro-food industries, textiles, garments, footwear, toys, and furniture).

The buyers, usually producers of branded products, are keen to maintain control of the marketing channels and the value of the brand and to avoid copying through protecting their intellectual property. Their strong market position is the result of their global brands and brands for a specific market or region.

Civil law system (*see also* "Common law system")

A civil law system is based on a detailed set of laws that make up a code which establishes what is legal or not, especially in contracting and commercial transactions. With regard to business transactions, in a civil law system the contracts negotiated and entered into

by the parties tend to be shorter and less detailed than in a common law system because most of the contractual aspects and related implications are contemplated in the civil code. By the same token, civil law tends to be less adversarial than common law.

Civil law is also called continental law because it prevails in most of continental Europe, for example in France and Germany. It derives from a code developed by the Roman Emperor Justinian and has influenced many legal systems around the world. Over 70 countries, including Japan and most South American countries, operate on a civil law basis.

Common law system (*see also* "Civil law system")

The common law, also called Anglo-American law, is the system prevailing in the United States, the United Kingdom and in many other English-speaking countries. Common law goes back to ancient kings who used to make legal decisions on a case by case basis; it is a system based on tradition, precedent, and custom and usage. The courts play an important role by interpreting events in line with earlier decisions in similar cases, the so-called precedents. For this reason, the common law is also called case law.

In a common law system, the contracts tend to be detailed, covering all anticipated problems and envisaged solutions so that, in the event of litigation, the court would arrive at an undisputable solution whatever the precedent used. As an example: if a judge once refused damages because the plaintiff had incurred "costs" while the contract spoke only of "expenses", future contracts will tend to speak of "costs and expenses", thus avoiding the problem of interpretation.

Competitiveness

For an enterprise, competitiveness refers to the capacity to create and sustain cost and/or product advantages in order to gain or maintain a strong position in the markets for its products and a high level of profitability. In general, the advantages are based on the ability of a firm to:

(a) successfully define its scope;
(b) manage and coordinate the core functions and operations within the enterprise as well as relationships with suppliers and customers; and
(c) be aware of market demand characteristics and respond to them appropriately.

The OECD defines the competitiveness of a country as "the degree to which a country can, under free and fair market conditions, produce goods and services which meet the test of international markets, whilst simultaneously maintaining and expanding the real incomes of its people on a long-term".

The European Commission attempts to encompass entities other than countries in the following definition of competitiveness as: "the capacity of businesses, industrial regions, nations or supra-national associations exposed, to secure an internationally competitive position, to secure a relatively high return on the factors of production and relatively high employment levels on a sustainable basis".

Corporate social responsibility (CSR)

There are various definitions of "corporate social responsibility (CSR)". According to the World Business Council for Sustainable Development, CSR is "The continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as that of the local community and society at large".

The European Commission defines CSR in this way: "Being socially responsible means not only fulfilling legal expectations but also going beyond compliance and investing more into human capital, the environment and relations with stakeholders".

According to Business for Social Responsibility, CSR means "Operating a business in a manner that meets or exceeds the ethical, legal, commercial and public expectations that society has of business."

Due diligence

Due diligence is a process through which a party interested in a business undertaking, rigorously evaluates all the information and data which are critical for successfully achieving the envisaged objectives. Examples of situations calling for due diligence procedures are acquisitions, venture capital investments and joint venture. An effective due-diligence process in complex and high-risk cases may require the examination of hundreds of items, and involve investment banks, lawyers and management consultants. However, firms that are active in business areas requiring due diligence procedures may form their own due diligence services.

In the case of a joint venture, the due diligence process would focus on such aspects as market and competition, the nature and suitability of the technology, its costs and impact on profitability, the potential partner's soundness and personality, commercial reputation, cultural fit and management practices, and the firm's commercial standing.

Each potential partner may do confidential checks on the other through various business contacts, namely suppliers, customers, banks and trade associations, or through business consultants.

Factor conditions; factor markets

Factor conditions include all the inputs that enterprises need to conduct and sustain a business and a production process. Typically, this includes human resources (skilled and unskilled labour), physical resources (weather, water ways, minerals and agricultural products), knowledge (education system, research and development, and industrial knowledge), capital resources (availability of debt and equity capital), and infrastructure (roads, ports, energy and communications. Flexible and responsive factor markets are vital to building and deploying industrial capabilities. Clear and supportive rules of the game induce enterprises to make long-term investments in innovation and learning.

According to Porter, four conditions are important for competitive superiority: (a) factor conditions, (b) demand conditions, (c) related and supporting industries, and (d) firm strategy, structure and rivalry. Porter represented these conditions in a framework

called "Porter diamond", which is a useful tool for understanding how and where globally competitive companies develop.

Feasibility studies (*see also* "Opportunity studies" and "Pre-feasibility studies")

A feasibility study must provide a sound basis for the final investment decision. It should define and analyse the critical elements related to the production of a given product, together with alternative approaches to such production. A feasibility study should also determine a defined production capacity at a selected location, using a specific technology, in relation to defined material inputs, at identified investment expenditures and production costs, as well as sales revenues for an identified market at a calculated return of investment.

To reach this objective, an iterative process has to be launched with a cycle of feedbacks and interlinkages covering possible alternative solutions for technology, production programmes, location, site and plant, mechanical, electrical and civil engineering and the organizational set-up that all have to be harmonized to minimize investment and production costs.

If the resulting data show a non-viable project, the critical parameters should be adjusted in an attempt to present a well-defined viable project. The feasibility study should describe this optimization process, justify the assumptions made and the solutions selected, and define the scope of the project as well as the integration of the selected alternatives. If, however, it is not viable despite all the alternatives reviewed, this should be stated and justified in the study.

Global supply chains (*see* "Global value chains")

Global value chains

The terms value chains and supply chains (and global value chains and global supply chains when the terms are used in association with globally organized operations) are currently used interchangeably, and encompass the sequence of related and dependent activities that are needed to bring a product or service from conception, through different phases of production, to delivery to final consumers and on to after sales services and, finally, to disposal or recycling. But the term value chain, in particular, represents a concept introduced by Porter (1985)[70] to underscore the idea that every business is a collection of activities to design, produce, market, deliver and support its product, in a sequence that he terms "value chain". The activities are called "value activities", and through them the firm creates a product of value to its customers. In monetary terms, the total value of a product to customers is higher than the total cost of the value activities, and the difference represents the margin to the firm. (*See also* "Buyer-driven value chains" and "Producer-driven value chains".)

Innovation and learning

For developing countries and their firms, the development of competitive capabilities requires a conscious effort of innovation and learning, a process that involves the ability to draw on skills and inputs from others—suppliers, customers and also competitors—in order to deploy new production and management technologies, upgrade them over time and ultimately create new technologies.

[70] *Source:* Kauffman, Ralph G., *op. cit.*

Innovation and learning are interactive processes that work best in networks of efficient enterprises, institutions and markets. Enterprises in developing countries generally start the innovation and learning process by importing new technology; they then invest in building their capabilities to master the tacit elements, adapt to local conditions and keep advancing technologically by developing new processes, products and services as a source of competitive advantage.

Innovation and value chains[71]

Innovation for global value chains can involve improving capabilities in production; developing new capabilities outside production (design and marketing skills); diversifying customers and market destinations; and developing a capacity to introduce new products. In this connection, four kinds of innovation can be distinguished:

Process innovation: consists of improving the efficiency of internal processes so that these are significantly better than those of rivals, both in individual links in the chain (e.g. cutting the cost of inventories or lowering scrap) and between the links in the chain (e.g., more frequent, smaller and non-timely deliveries).

Product innovation: consists of improving all the products through quality and price performance and through time to market, or differentiating themselves from rivals by introducing new products faster. It involves changing new product development processes in individual links in the value chain and in the relationship between different chain links.

Functional innovation: implies raising value-added by changing the mix of activities conducted in the firm.

Inter-chain innovation: assumes moving to a new, more profitable value chain where higher rents can be captured (e.g., Taiwan Province of China firms moved from the manufacture of transistor radios to calculators, to TVs, to computer monitors, to laptops and now to Wireless Application Protocol phones (WAP)).

Intelligent organization

Organizations are confronted with increasing complexity and speed of change in the global business environment, and new forms of competition that require fast adaptation and response. To deal with these challenges, organizations have to "become intelligent", able to take advantage of the disperse knowledge of their members and learn more quickly than competitors about their internal and external environment. The development of an intelligent organization is based on organizational learning and knowledge management. Effective intelligent organizations are concerned with the creation of organizational knowledge by taking advantage of their core competencies in terms of explicit knowledge (codified and documented) and implicit knowledge (tacit knowledge, based on individual experience). The knowledge management in an intelligent organization has to be based on a culture and a set of values cutting across the different organization's layers and encouraging questioning and creativity, freedom of speech, access to and sharing of information in a spirit of team work, trust and a sense of common purpose. The knowledge management should be supported by an efficient

[71]UNIDO, 2004.

organizational infrastructure, including information and communication technology that facilitates the diffusion of knowledge within the organization as well as organizational and individual learning.

Life cycle (*see* "Technology Life Cycle")

Linking, leveraging and learning

The concept of "linking, leveraging and learning" captures what firms—and countries as well—have to do to foster their technological development

Linking: connecting with outsiders to acquire needed technologies and skills; this includes the identification of partners with whom capability enhancements is feasible.

Leveraging: going beyond arms-length transactions to squeeze as much as possible from the new relationships with those outsiders; the leveraging phase requires a strategic choice and specifies the means of knowledge acquisition (how do we get what we want?)

Learning: making the many efforts needed to master technological processes, consciously building the foundation for improving current technologies—and creating new ones. Different forms of learning are feasible—learning by doing, learning by interacting, learning by monitoring and learning by formal training. The choice will depend on the type of linkage and leveraging involved. The learning process is difficult and complex; it lies at the heart of the arduous process of industrial innovation and development

National innovation system

A national system of innovation may be defined as a network of public and private institutions, located within national borders, whose activities and interactions enable the generation, importation, simulation, dissemination, fusion and economical use of knowledge. In a national system of innovation there is an interaction between five main subsystems: productive (including public and private firms performing their activities in the country); scientific and technological (encompassing diverse institutions, such as a research centres or technology diffusion organizations); education and training (educational organizations at the various levels and training institutions); financial (including banking, insurance and, in general, all the organizations that provide financial support for launching innovative endeavours); and the administrative-regulatory system (public institutions that lay the ground work, define the rules of the game and provide the incentives for innovative activities).

OEM—original equipment manufacture

OEM involves contract manufacturing by a local firm for foreign multinational enterprises which sell products under their own brand names. In a typical OEM relationship, multinational enterprises provide the local firm with the specifications of the products and often assist with selecting equipment, training engineers and providing advice on technology and management for OEM. All this gives the local firm an opportunity for learning and technological upgrading. The assimilation of foreign technology is a point of departure for their own technological advances through R&D and innovation, the

redesigning of products and the development of new products, the creation of their own brands, and achieving the capability to compete in foreign markets, acquire further advanced technologies and skills and become a global player.

Opportunity studies (*see also* "Pre-feasibility studies" and "Feasibility studies")

This type of study identifies investment opportunities by developing project ideas and analysing the following:

(a) availability of the natural resources needed to implement the envisaged industry;
(b) future demand for goods that have growth potential as a result of increased population or purchasing power;
(c) current imports, in order to identify areas for import substitution;
(d) possible linkages with other industries, indigenous or international;
(e) possible extension of existing production lines by backward or forward integration, as in the petrochemical industry;
(f) possibilities for diversification;
(g) possible expansion of the existing industrial capacity to attain economies of scale;
(h) the general investment climate;
(i) industrial policies;
(j) cost and availability of production factors; and
(k) export possibilities. Opportunity studies are rather sketchy by nature and rely more on aggregate estimates than on detailed analysis.

Pre-feasibility studies (*see also* "Opportunity studies" and "Feasibility studies")

When a project opportunity has been identified as one to be pursued further, a more elaborate study has to be carried out to facilitate the taking of definite decisions on the project in question. This may suggest the need for a detailed techno-economic study, called a feasibility study which is a costly and time consuming undertaking. Consequently, prior to allocating funds to such a study, a preliminary assessment is usually made in a pre-feasibility study, the main objectives of which are to establish if:

(a) the investment opportunity is so promising that an investment decision can be taken on the basis of the information elaborated at the pre-feasibility stage;
(b) the project concept justifies a detailed analysis in a feasibility study;
(c) there is an aspect or a parameter of the project that is critical to the feasibility and necessitates an in-depth investigation through functional and support studies such as market surveys, laboratory and plant tests, etc.; and
(d) the information is adequate to decide that the project is neither a viable proposition nor attractive enough for a potential investor.

Private equity firms; private equity funds

Private equity is a term used to designate the holding of shares in companies that are not listed and quoted on a public stock exchange. By nature, private equity is not freely tradable on a public stock market. Private equity firms usually get their funds from institutional investors, such as pension funds, insurance companies, financial institutions and individuals with substantial wealth, who seek high returns in long-term investments

and are ready to lock-up their money for relatively long periods, up to ten years or even more. Private equity funds are also referred to as limited partnerships. The investment decisions are made by the General Partner whose compensation is a management fee (a percentage of the fund's total equity capital) and a performance fee (based on the profits achieved). The investors are limited partners who have no say in the investment decisions and only share the profits when the investments are converted to cash. The profits can be obtained in various ways, for example by buying shares in private companies and selling them later at a higher price.

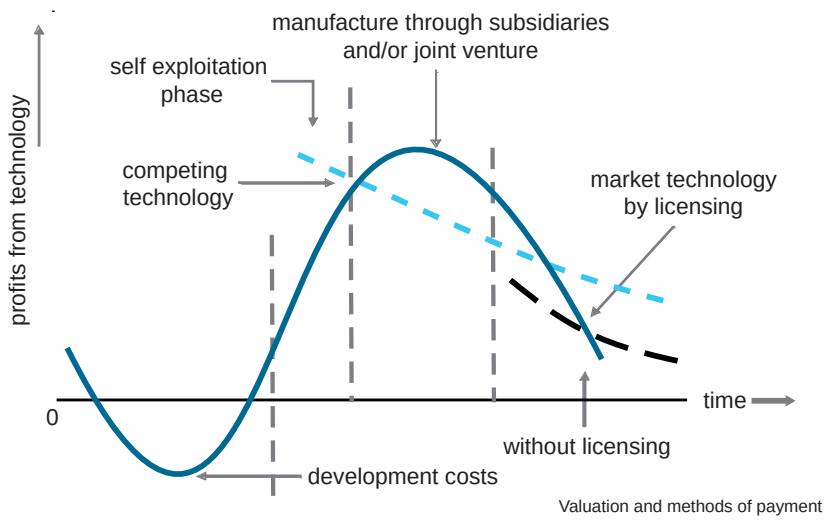
Producer-driven value chains (*see* "Buyer-driven value chains")

In this case, key producers in the chain control vital technologies which are of crucial importance for positioning in the final product market. They coordinate these value chains and take responsibility for helping the efficiency efforts of their suppliers and customers. These chains are typical for medium- and high-tech industries, like automobiles, electronics, telecommunications, and the like. (*See also* "Global value chains")

Technology life-cycle

The development, use and profitability of a certain technology can be represented by a so-called technology life-cycle curve with four phases: the development phase (the developer is incurring costs, i.e. no profit accrues in this phase); the growth phase or ascending phase (the curve shows the ascending path of successful technologies); the maturity phase (the phase of established, tested technologies); the flatness of the curve can be short or long, depending on competitive forces; and the decline and decay phase (the technology loses momentum, for instance when patent protection expires or as a result of emerging and displacing technologies). In the present development scenario characterized by an increasingly rapid pace of innovation, the technology life cycles have a tendency to become increasingly shorter.

The technology life-cycle curve



Supply chains (*see* "Global supply chains")

Value chains (*see* "Global value chains")

Virtual corporation

The concept of virtual corporation is associated, on the one hand, to the trend of firms to outsource as many as possible of their functions and, on the other hand, to the possibilities opened by the information and communication technologies that allow the management and control of complex networks of spatially dispersed operations. As a minimum, a virtual corporation subcontracts almost all of the organization's activities, including design, manufacturing and marketing, and does not need to have a large number of regular employees to be a major player. However, it can be argued that such a virtual corporation may degenerate into a "hollow corporation" that loses the capability to evolve and adapt to changing circumstances. In a more realistic approach, virtual corporations rely extensively on outsourcing and collaborative networks but remain centreed on a core business with a high integration of design activities and relations with customers.

Zaibatsu

The term *zaibatsu* refers to large, family-owned Japanese businesses that existed in the nineteenth century and the first half of the twentieth century. Examples are Mitsui, Mitsubishi, Sumitomo, Yasuda, Kawasaki, Nissan, among others. The *zaibatsu* were composed of financial and manufacturing companies, usually held together by a large and powerful holding company that exerted a vertically integrated chain of command. They were outlawed by reformers during the Allied occupation of Japan after World War II, but the families and relationships did not disappear and the *zaibatsu* reformed into the *keiretsu* organizations, with predominantly horizontal relationships rather than the old vertically integrated ones, and organizational and overall characteristics more in line with the requisites of the newly established laws.[72]

[72] *Sources: (a)* Daniels, 2004; *(b)* Wikipedia.

SAMPLE

JOINT VENTURE AGREEMENT

The joint venture company

This Agreement is made and entered into on [day] of [month, year] by and between: [name of the foreign company], a company organized under the laws of [country of the foreign company] having its principal office at [address of the foreign company], hereinafter referred to as FOREIGN; and [name of the local company], a company organized under the laws of [host country] having its principal office at [address of the local company], hereinafter referred to as LOCAL.

Recitals

WHEREAS the government of [host country] passed a Joint Venture Law on [date] permitting the establishment in [host country] of private companies with participation from developed and developing countries;

WHEREAS LOCAL has performed, at its own expense, market and pre-feasibility studies of a joint venture for the establishment of a production facility for [product 1] and their sales initially in [host country] and eventually abroad and for the expansion of already existing production facilities for [product 2] in [host country] for sales abroad.

WHEREAS LOCAL and FOREIGN entered into a Letter of Intent on [date] under which LOCAL and FOREIGN undertook to conduct jointly a feasibility study to analyze and evaluate the potential for such a joint venture between LOCAL and FOREIGN;

WHEREAS the feasibility study carried out by the consulting firm [name of consulting firm] pursuant to the above mentioned Letter of Intent demonstrated the viability of establishing such a joint venture and has indicated the likelihood of a 60 per cent increase in sales of [product 2] to FOREIGN and a feasible sales volume for [product 1] of 25,200 units per annum at full capacity;

WHEREAS LOCAL has applied for and been granted permission from the Board of Investments of [host country] to form a joint venture with FOREIGN for the purposes outlined below;

WHEREAS LOCAL and FOREIGN now wish to enter into a joint venture for the production of [product 1] and [product 2] in [host country].

NOW THEREFORE, in consideration of the mutual representations, warranties, covenants, and agreements herein contained, LOCAL and FOREIGN agree as follows:

1 Formation of the joint venture company

On or before the [day] of [month, year], the parties hereto shall cause the formation of a private joint venture company under the laws of [host country] as follows:

1.1 The joint venture company shall be called [name given to the joint venture company] hereinafter referred to as JOINT COMPANY.

1.2 JOINT COMPANY shall be limited by shares and have an authorized share capital of US$20.0 million [host country] currency units (hereinafter referred to as "CU") divided into 10,000 class A common shares having a par value of CU 1000 each and having voter's rights at all shareholder's meetings; and 14 class B ordinary shares having no par value but bearing rights to membership on the Board of Directors, and 10,000 cumulative preferred shares having a par value of CU 1000 each and having rights to priority in the receipt of dividends and participation from assets in case of dissolution.

1.3 JOINT COMPANY's initial issued share capital shall be 8,000 class A common shares, 14 class B ordinary shares, and 8,000 (cumulative) preferred shares and shall be subscribed by the parties in the following proportions to their respective equity ownership:

LOCAL:	Common shares, class A:	4,080
	Common shares, class B:	6
	Cumulative preferred shares:	4,080
FOREIGN:	Common shares, class A:	3,920
	Common shares, class B:	8
	Cumulative preferred shares:	3,920

1.4 JOINT COMPANY shall have its registered and principal offices at [address of JOINT COMPANY].

1.5 JOINT COMPANY's by-laws and articles of association shall be as set out in appendix A which is attached hereto and made a part hereof.

2 Objectives of the JOINT COMPANY

The objectives of the JOINT COMPANY are:

2.1 General objectives

- To develop modern [product 1] production and marketing in [host country]; expand and upgrade existing [product 2] production and sales facilities for export.

2.2 [product 2] production:

- to obtain foreign currency through the sale abroad of locally made
- [product 2];

- to provide employment for the local labour force;
- to establish a new market for locally manufactured [product 2];
- to safeguard the already existing market for furniture in [country of FOREIGN] by obtaining a product produced at lower cost in [host country];
- to secure advanced [product 1] manufacturing know-how and design and modernize the already existing local [product 1] industry;
- to utilize an abundant natural resource;
- to safeguard the raw material supply required for the [country of FOREIGN] [product 2] market.

2.3 [product 1] production:

- to secure advanced electronic know-how;
- to develop low cost [product 1] for [host country] home market through local production and to upgrade thereby the local level of computer sophistication;
- to obtain management know-how for a [product 1] production plant;
- to obtain cost and other advantages through [host country]'s low labour and raw materials costs, tax and other incentives;
- to establish a new market in [host country] and possibly abroad for [product 1] and related parts;
- to obtain foreign currency in the event that [product 1] and related parts are sold abroad.

3 Expansion and future growth of operations

Each party shall take such action as may be necessary to ensure that JOINT COMPANY shall progressively develop and expand the joint [product 1] production and [product 2] production to the maximum extent consistent with sound commercial practice.

4 JOINT COMPANY's future share and loan capital requirements

4.1 Should JOINT COMPANY decide to export outside the territory of [host country] the [product 1] which it produces under this contract, LOCAL and FOREIGN will jointly undertake during the period of three years starting on the first day of [date] to make additional contributions to JOINT COMPANY at its request up to an aggregate of CU 10.0 million.

4.2 Each such contribution shall be divided between the parties in proportion to their respective equity ownership. Not more than 50 per cent of such contributions shall be requested before [date] and not more than 75 per cent total of such contributions before [date].

4.3 Any further equity may be issued by the JOINT COMPANY in excess of the above equity contribution requirements, provided, however, that shares representing such equity shall be offered for subscription in the first instance to the parties in proportion to their respective equity ownership and that any such further equity shares shall be issued for subscription at a price per share equal to the book value per share of the company as of the end of its immediately preceding fiscal year.

4.4 The parties agree that no additional equity contributions will be required to be made to JOINT COMPANY during the six year period following the formation thereof beyond the initial equity contribution provided under section 1 of this Agreement.

4.5 The parties agree that any additional financial requirements of JOINT COMPANY shall be met through borrowing. To the extent that any such borrowing should not be available to JOINT COMPANY without the assistance of guarantees by either party, the parties shall supply such guarantees provided that at no time shall LOCAL's exposure for such guarantees be in currency other than CU or exceed the amount of CU 7.5 million and that FOREIGN's exposure for such guarantees shall not exceed the amount of CU 6.0 or the equivalent thereof.

4.6 The exchange rate for any operation under this contract shall be the average of the exchange rates of buying and selling published by the National Foreign Exchange Bureau of [host country] on the date that the said operation takes place.

5 Parties' contributions to and contractual relations with JOINT COMPANY

5.1 LOCAL shall contribute to JOINT COMPANY in total fulfillment of its contribution to the initial share capital of JOINT COMPANY in accordance with the preceding section 1 of this Agreement the facilities and other assets listed in appendices B and F.

5.2 FOREIGN shall contribute to JOINT COMPANY in total fulfillment of its contribution to the initial share capital of JOINT COMPANY in accordance with the preceding section 1 of the Agreement the facilities and other assets listed in appendix C.

5.3 The parties agree to accept the evaluation of said facilities and other assets found in the feasibility study.

[ALTERNATIVE WORDING: In the event that both parties agree that, because of time lapse since the feasibility study, the evaluation found in the feasibility study no longer represents the true value of the facilities and/or assets described therein, they will use their best efforts to arrive at an evaluation satisfactory to both parties. If, however, despite their best efforts, they should fail to reach such conclusive agreement with respect to any such item prior to [date], the final evaluation shall be conclusively determined by (independent chartered accountant or other third party agreeable to both sides) at fair market value in the country and city where located. The valuation determined by said third party shall be final and binding for the parties who shall bear the costs of his/her services in equal shares.]

5.4 All contractual and other commercial dealings, including supplies of all kinds, between either party or its respective affiliates and JOINT COMPANY shall be negotiated on a commercial arm's length basis. Upon its request, each party shall have the right to be informed by JOINT COMPANY annually of the prices applied with respect to dealings contemplated in this provision in order that it may review compliance with the principles set out herein.

5.5 Prices of material or equipment supplied by either party or its respective affiliates to JOINT COMPANY shall be negotiated having regard to prices of similar products

and services sold or supplied by independent suppliers to their most preferred customer. Where similar products are not available from independent suppliers, prices shall be negotiated on the basis of bearable cost plus a mark-up.

6 Incentives

6.1 This agreement is made subject to JOINT COMPANY's continuing to be admitted to the benefits of the following incentives under the Joint Venture Law of [date], other pertinent legislation and regulations of [host country], and the [host country]/[country of FOREIGN] double taxation treaty.

6.1.1 Tariffs and other forms of protection:

- Seven year import tariff of 100 per cent on purchase price of competing goods from other countries;

6.1.2 Import-duty concessions:

- import restrictions for three years thereafter and limiting permitted imports to a one quarter of the number produced in the proceeding year by JOINT COMPANY;

6.1.3 Tax incentives:

- tax rate on salaries of individual expatriate employees reduced to the same tax rate as in [country of FOREIGN];
- exemption from the 20 per cent export tax on profits (in accordance with the [host country]/ [country of FOREIGN] double taxation treaty;
- reduction of the tax on profits from 38 per cent to 33 per cent.

6.2 [host country] shall immediately upon signing this agreement duly file any further applications necessary for the above incentives to the competent authorities and shall comply with any requirement prescribed in connection therewith.

7 Marketing

7.1 Marketing of the [product 2] of JOINT COMPANY shall be conducted by FOREIGN in accordance with the terms set forth in the marketing agreement annexed hereto in appendix D.

7.2 Marketing of the [product 1] in [host country] under this Agreement shall be conducted by LOCAL in [host country] and by FOREIGN abroad in accordance with the terms set forth in the marketing agreement annexed hereto in appendix E.

8 Board of Directors

8.1 JOINT COMPANY shall be directed by a Board of Directors which shall consist of a total of seven members of whom four shall be nominees of FOREIGN and three

shall be nominees of LOCAL for so long as the proportion of ownership in the Company is 49 per cent by FOREIGN and 51 per cent by LOCAL. If the proportion of ownership is altered by any means whatsoever, this alteration shall be reflected in the proportion of the members of the Board of Directors nominated by each party at the meeting of the shareholders at which the said alteration of proportion of ownership is approved.

[ALTERNATIVE WORDING: FOREIGN shall be the owner of 8 class B shares and shall be entitled to make binding nominations for the appointment of four of the directors, and LOCAL shall be the owner of 6 class B shares and shall be entitled to make binding nominations for the appointment of three directors. Both parties agree to take all steps necessary to secure the appointment of the said nominees in accordance with the law of [host country].]

8.2 Should one of the positions on the Board of Directors become vacant for any reason whatsoever, the partner who originally nominated the holder of the position now vacant shall have the right to appoint another director to fill out the remainder of the term of the vacant position.

8.3 Each party shall exercise its voting rights in JOINT COMPANY and take such other steps as lie within its power:

> 8.3.1 to procure that the persons nominated in accordance with the preceding paragraph shall be directors of JOINT COMPANY; and
> 8.3.2 to prevent the passing of any resolution for the removal of any director nominated by the other party, except at the request, or with the consent of, that other party.

8.4 LOCAL will use its best efforts to remove obstacles to temporary visas for FOREIGN board members attending board meetings in [host country].

8.5 The Board of Directors shall hold at least one regular meeting annually. A special meeting shall be held upon the recommendation of at least three of the directors.

8.6 The meetings of the Board of Directors shall be normally held at the headquarters of JOINT COMPANY. Upon approval of all directors, it may be held at other locations.

8.7 The Chairperson shall send each director a written notice indicating the agenda, time and place of any meeting 30 days prior to the said meeting.

8.8 If a Director is unable to attend any meeting, he may designate in writing another person as a proxy to attend the meeting.

8.9 A quorum for a meeting of the Board of Directors shall consist of at least six Directors.

8.10 The written minutes of each meeting of the Board of Directors shall be signed by all Directors attending. The minutes will be in [host country language] and English and will be filed in JOINT COMPANY's headquarters.

8.11 Unanimous approval of the Board of Directors is required for the following issues:

8.11.1 Approval of reports submitted by the general management, such as production plans, annual business operation reports, loan statements;
8.11.2 Approval of the annual financial statements, including profit and loss accounts;
8.11.3 Approval of major corporate regulations and rules;
8.11.4 Approval for amendments of JOINT COMPANY's articles of association;
8.11.5 Approval of any bankruptcy petition for JOINT COMPANY;
8.11.6 Approval of extension of the term of JOINT COMPANY;

8.12 Approval of five or more directors is required for the following issues:

8.12.1 Approval of managing director's normal operation plan;
8.12.2 Approval of corporate working regulations and rules including the policies concerning bonuses;
8.12.3 Approval of decisions made by the general manager and the deputy general managers concerning the day-to-day operation of JOINT COMPANY.

9 Management of JOINT COMPANY

9.1 LOCAL shall appoint a general manager who will be responsible for all non-technical questions in the day-to-day management of JOINT COMPANY under the direction and control of the Board of Directors.

9.2 FOREIGN shall appoint two deputy general managers for the first five years of JOINT COMPANY's operation. One deputy general manager will be responsible under the direction and control of the Board of Directors for the setting up of the [product 1] production operation with sales in [host country] and will be responsible for recommending to the Board of Directors if and when sales should begin outside [host country]. The other deputy general manager will be responsible for the [product 2] production operation and will be responsible under the direction and control of the Board of Directors for modernizing and upgrading the standards of wood furniture production and for overseeing the adherence to specifications provided by FOREIGN, including the installation of new equipment and the quality control of the final product.

9.3 After the first five years of JOINT COMPANY's operation, the Board of Directors shall decide whether to market [product 1] produced in [host country] in other countries. If such decision is taken, FOREIGN will have the right to appoint a third deputy general manager and an assistant deputy general manager who will have responsibilities for sales outside [country of FOREIGN] during the next five-year period. In such case, FOREIGN will also provide JOINT COMPANY at cost, without any charge for creative work, all advertising and marketing aids which it then has or will acquire during the term of this Agreement and which relate to [product 1] sold by JOINT COMPANY outside [host country]. More specifically, but without limiting the generality of the foregoing, such advertising and marketing aids shall include brochures, pamphlets, catalogue sheets, labels, boxes, cartons, packaging, diagrams, manuals, designs,

pictures, descriptions, instructions, films, scripts, recordings, colour schemes and other data designed to explain, assist or promote the sale, distribution, use and servicing of the said computers.

9.4 The [product 1] division will have four additional managers for the first five years of JOINT COMPANY's operations: a technical director and a financial director appointed by FOREIGN and a marketing director and a personnel director appointed by LOCAL

9.5 The [product 2] division will have four additional managers: a technical director and a marketing director appointed by FOREIGN and a financial director and a personnel director appointed by LOCAL.

9.6 LOCAL will use its best efforts to remove obstacles to employment permits for foreign management in [host country].

10 Shareholders' rights

10.1 As long as either party holds at least 45 per cent of the equity securities of JOINT COMPANY, none of the following actions shall be taken without the consent of both parties:

10.1.1 Amendment of the by-laws or articles of incorporation;
10.1.2 Increase of capital;
10.1.3 Distribution of dividends;
10.1.4 Merger or consolidation with another company or companies;
10.1.5 Appointment or removal of the independent auditor of JOINT COMPANY;
10.1.6 Dissolution, transfer of any substantial part of the assets, or institution of any fundamental change in the nature of the business.

10.2 The parties shall cause JOINT COMPANY at the close of each fiscal year to have an audit conducted by an independent firm of chartered accountants acceptable to both parties, and to present to its shareholders an annual report covering such year, including financial statements certified by such accountants as having been prepared in accordance with the standards established in [host country] for state-owned enterprises.

10.3 As early as practicable after the formation of JOINT COMPANY, the parties shall cause the JOINT COMPANY to provide both parties with at least quarterly financial and operating reports, business plans and forecasts, prepared on principles consistent with those set out for JOINT COMPANY's annual reports.

10.4 The parties are requesting that JOINT COMPANY be exempted from the [host country] Joint Venture Law requirement that joint venture auditing be carried out by an [host country] auditing organization operating on a self-supporting basis and that joint venture not submit any accounting or business information to the state or other authorities of foreign countries as [country of FOREIGN] requires FOREIGN to submit tax and other information about its subsidiaries in its accounting documents which must be prepared in line with generally accepted accounting standards. If such authorization is granted, JOINT COMPANY will employ [name of auditing firm] to prepare its accounts.

11 Transfer of shares

Neither party shall, without the previous written consent of the other party, sell, transfer, pledge, encumber, dispose of, or otherwise part with the beneficial ownership of, any of its shares of the capital of JOINT COMPANY.

12 Profit policy

12.1 LOCAL and FOREIGN recognize that their own and the best interests of JOINT COMPANY will be best served by taking all reasonable steps to ensure the expansion of the production facilities of the joint company as rapidly as market conditions permit and, to this end, agree to retain sufficient earnings in JOINT COMPANY before distributing profits to the shareholders, as shall be reasonably required in the circumstances to provide for such expansion and for the other requirements of conducting the affairs of JOINT COMPANY according to sound business practices.

13 Patent rights

FOREIGN is the owner of certain patents outlined in the Foreign Patent Licence Agreement in appendix F and has the right of disposal of the said patents. FOREIGN agrees to licence LOCAL which undertakes to assign said licence to JOINT COMPANY to permit JOINT COMPANY to use these patents and the manufacturing secrets and experience (know-how) concerning the manufacture of the [product 1] to be assembled by JOINT COMPANY and the [product 2] to be produced by JOINT COMPANY for a period of time not to exceed the present term of JOINT COMPANY, i.e. not longer than fifteen years from the date JOINT COMPANY comes into existence as a legal entity.

14 Duration of agreement

14.1 This Agreement shall enter into effect on the date of its registration in accordance with the laws of [host country] and shall remain in effect for a period of fifteen years therefrom and shall be subject to renegotiation at the end of the period.

14.2 Should the parties fail to agree within a period of three months following the end of the fifteen year period on the renegotiation of the Agreement or on termination of the Agreement under section 15 of this Agreement, LOCAL shall have the option to acquire the shares in the Company then held by FOREIGN at a valuation to be calculated by the auditor of JOINT COMPANY on the basis of the net tangible assets of JOINT COMPANY as disclosed in the latest audited accounts.

15 Termination of the Agreement

15.1 Either party may terminate this Agreement in the event that the other party shall:

15.1.1 Breach in any material manner any provision of this Agreement and fail to remedy such breach within 60 days after the injured party has given written

notice requiring that the breach be remedied or such longer period as the injured party may specify as reasonable in the circumstances;

15.1.2 Commit any act of bankruptcy, become insolvent, enter into any agreement with its creditors, take advantage of any law for the benefit of debtors, go into liquidation, whether compulsory or voluntary, or have a dissolution order made in respect of it.

15.2 The effective date of termination of this Agreement shall be the date on which the injured party gives written notice to that effect in accordance with this clause.

15.3 Any termination pursuant to this clause shall be without prejudice to any rights and remedies which the injured party may seek against JOINT COMPANY or the other party for breach of contract or otherwise and shall not operate to prejudice the rights and obligations provided for in the [host country] Joint Venture Law or this Agreement concerning the disposition of shares and assets of JOINT COMPANY.

16 Distribution of assets on dissolution

In the event of the dissolution of the Company, the assets of the Company shall be disposed of in accordance with the following rules:

16.1 LOCAL shall be given a first option for a period of ninety (90) days to purchase all or any of such assets at their depreciated book value;

16.2 After the expiration of the first option, FOREIGN shall be given an option for a further period of ninety (90) days to purchase at their depreciated book value all or any assets not purchased under the first option;

16.3 Any remaining assets shall be disposed of in accordance with the directions of the liquidator of the Company.

17 Arbitration

Any dispute between the parties that cannot be settled by mutual agreement and that relates to the interpretation, carrying out of obligations, breach or enforcement of this Agreement, or of any document or instrument referred to herein, shall be finally settled under the Rules of Conciliation and Arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with the Rules. The arbitrator or arbitrators shall sit in Vienna, Austria.

18 General

18.1 This Agreement shall be construed in accordance with and governed by the laws of [host country].

18.2 This Agreement represents the entire understanding and agreement between the parties and supersedes any and all previous oral or written understandings or agree-

ments between the parties with respect to the matters set forth herein. Appendices annexed hereto are for all purposes an integral part of this Agreement.

18.3 No modification or amendment to this Agreement or any schedule or exhibit thereto and no waiver of any of the terms or conditions hereof or thereof shall be valid or binding unless made in writing duly signed.

18.4 Any notice or other communications to a party required or permitted hereunder shall be made in writing and shall be sent by cable or telex and confirmed by registered air mail addressed to the address of such party set forth below or to such other address as such party shall have communicated to the other party.

Notices or communications to LOCAL shall be sent to:

[Name of LOCAL, address, contact coordinates, contact person]

Notices or communications to FOREIGN shall be sent to:

[Name of LOCAL, address, contact coordinates, contact person]

18.5 Each party shall use its best efforts to secure any authorization by public authorities necessary for the execution and performance of this Agreement in accordance with its terms.

18.6 Each party represents and warrants that, except for any authorization specified under the preceding paragraph 18.5, it has full power and authority to execute and to fulfill all of its obligations set forth in this Agreement and that this Agreement constitutes a valid and binding agreement of such party in accordance with its terms.

18.7 The parties shall cause JOINT COMPANY, upon its registration, to become a party to this Agreement, whereupon JOINT COMPANY shall be entitled to the rights and bound by the obligations provided for the company herein. JOINT COMPANY shall deliver to each of the parties an appropriate document evidencing its agreement to such affect.

IN WITNESS WHEREOF, the parties have caused this Agreement to be executed by their duly authorized representatives on the day and year first above written.

By ----------

(LOCAL)

By ----------

(FOREIGN)

Appendix A

By-laws (articles of association)

The by-laws (American), articles of association (British) govern the internal affairs of the company. They may be altered from time to time as the need arises (subject to corporate laws and the general principles of corporate law laid down by the courts).

They commonly govern the following items:

- voting rights and proxies;
- relative powers of management and of the Board of Directors;
- meetings of shareholders and directors;
- powers of the general manager;
- dividend payments;
- share transfer rules;
- alteration of capital.

Appendix B

Contribution of LOCAL to initial share capital of JOINT COMPANY

Appendix C

Contribution of FOREIGN to initial share capital of JOINT COMPANY

Appendix D

Marketing agreement [product 2] of JOINT COMPANY

Appendix E

Marketing agreement [product 1] of JOINT COMPANY

Appendix F

Patent licensing agreement

Between FOREIGN whose principal office is [address] represented by [name and position], which is hereinafter called "the Licensor"

and

LOCAL whose principal office [address] represented by [name and position], which is hereinafter called "the Licensee".

Recitals

WHEREAS the Licensor is owner of patents [description] …….....

applied for at …….. on [dates] and has the right of disposal of the said patents;

WHEREAS non-exclusive licenses have already been granted in respect of these patents;

WHEREAS the Licensor further possesses manufacturing secrets and experience (know-how) concerning the manufacture of the subject matter of his Licence;

WHEREAS the aforementioned patents and know-how have already been the subject of exploitation by the patentee, the Licensor having manufactured [product 1] and [product 2] [description] …….....

IT IS AGREED BETWEEN THE PARTIES AS FOLLOWS:

1 Technical field of application

This Licence is limited to the following uses:

[description] .....

2 Nature of the Licence

2.1 The Licence is for making, using and vending;

2.2 The Licence is non-exclusive;

2.3 The Licence is assignable only to the JOINT COMPANY, and the Licensee shall not assign his rights or obligations hereunder to any third party other than the JOINT COMPANY Joint Venture Company. Without prejudice to the generality of the foregoing, the Licensee shall not without the consent of the Licensor bring the Licence into the assets of a company.

3 Sublicences

The Licensee shall not grant sublicences.

4 Territory

4.1 The present Licence is granted for the territory of [host country]. The Licensee shall not manufacture in other territories, including those in which the Licensor does not enjoy any protection.

4.2 In the case of [product 2], the Licensee is authorized to export only to [country of FOREIGN]. He shall not export to other territories, including those in which the Licensor does not enjoy any protection.

4.3 In the case of [product 1], the Licensee is authorized to export only to [country of FOREIGN] for the first eight years of operation of the JOINT COMPANY. If the Board of Directors of the JOINT COMPANY by a unanimous decision decides to permit exports of the [product 1] produced in [host country] at any time after the first eight years of operation of the JOINT COMPANY, the Licensee shall be entitled to export to any other territory to which the Board of Directors of the JOINT COMPANY by unanimous decision decides to export the said [product 1] to.

4.4 For each and every breach of his above mentioned obligations, the Licensee shall pay to the Licensor US Dollars ..... as liquidated damages. The Licensee shall further forbid the export by his purchasers of articles to which this Licence applies to the extent that such export is forbidden by the preceding provisions of this Clause and shall impose on such purchases a liability to pay to the Licensor US Dollars ..... as liquidated damages in respect of each and every breach of their obligations not to export.

5 Registration of Licence

Either party shall be entitled to register the Licence at the Patent Office if such registration is permissible under the law of the country or countries in respect of which the Licence is granted. The Licensor shall give the Licensee any powers and authorizations necessary for this purpose. The expenses of registration shall be borne by the party desiring to register the Licence.

6 Drawings and descriptive documents

The Licensor shall supply to the Licensee all existing reproducible drawings, plans, and other technical documents required for manufacturing the subject matter of the Licence. The Licensee shall treat such drawings and documents as secret during and after the term of the Agreement.

7 Responsibility for claims by third parties

If the use of the patent(s) forming the basis of this Agreement results in a claim for infringement against the Licensee, the costs for the defense and any damages awarded against him shall be shared by both parties. The costs and expenses of any counter-claim or of settling a claim shall be shared by both parties. The Licensee shall inform the Licensor of any claim made against the licensee for infringement and shall enable the Licensor to join in any legal proceedings.

8 Novelty

The Licensor does not warrant the novelty of his/her invention, but should it transpire that the patent is void by reason of its publication, whether wittingly or unwittingly, by the Licensor before a patent was applied for, the Licensee shall be entitled to terminate the Agreement wholly or in part by sending a notice in writing to the Licensor.

9 Manufacture

The Licensor undertakes no responsibility for the risks of industrial manufacture which are assumed solely by the Licensee. The Licensee declares that s/he is familiar with the subject matter of the Licence, and s/he shall undertake its manufacture. If s/he fails to do so within one year from the date of setting up of the JOINT COMPANY Joint Venture Company, the Licensor shall be entitled to terminate this Agreement.

10 Commercial exploitation

The Licensor does not warrant that the invention is capable of commercial exploitation. The risks of such exploitation shall be assumed solely by the Licensee.

11 Quality control

11.1 The Licensee shall manufacture the subject matter at the same high level of quality as is done by the Licensor. The Licensor shall provide all necessary advice and information concerning his/her own experience in accordance with the provisions of sections ……. of this Agreement.

11.2 The Licensor shall be entitled to inspect whether articles manufactured under licence are of the agreed quality and to forbid the sale of articles of inferior quality.

12 Modifications and improvements in items under licence

12.1 The Licensor shall disclose and make available to the Licensee without charge any modification or improvement of the items under licence made during the term of the Agreement. The Licensor shall not be entitled thereby to any increase in royalties.

13 Modifications and improvements made by Licensee in items under this licence

13.1 The Licensee shall obtain the consent of the Licensor before undertaking modifications and improvements in the articles under this Licence.

13.2 The Licensor shall be entitled to make use of modifications and improvements suggested by the Licensee in consideration of reasonable payment on reasonable terms. This right shall not extend, however, to territories in which by virtue of the contract the Licensor is not entitled to manufacture or use the articles under licence. In default

of agreement on the amount and terms of payment the parties may refer the matter to arbitration in accordance with section …….. for the determination of the said amount and terms.

13.3 If the improvements are patentable the Licensor shall be entitled to patent them everywhere in consideration of reasonable payment on reasonable terms. In default of agreement on the amount and terms of payment the parties may refer the matter to arbitration in accordance with section …….. for the determination of the said amount and terms.

14 Payment on transfer of documents

Before drawings and documents are transferred the Licensee shall pay to account No …… at the …….. Bank the sum of CU 0.8 million. These drawings and documents will not be transferred to the Licensee unless and until the whole of the said sum has been paid to the …….. Bank. The Licensee shall not be entitled to the return of this sum by reason of the fact that this Agreement has for any reason been prematurely terminated.

15 Royalties

15.1 The Licensee shall pay in respect of each article produced under licence and sold by him/her one per cent of the sales price.

15.2 The right to royalty accrues when the item made under this Licence is dispatched from the Licensee's factory.

16 Taxes

16.1 Direct taxes payable in the Licensee's country by virtue of sums paid to the Licensor in accordance with the terms of the agreement will be for the Licensor's account.

16.2 Turnover taxes payable in the Licensee's country on such sums will be for the account of the Licensee.

16.3 When the law of the Licensee's country requires that turnover taxes must be paid by the Licensor, the Licensee shall provide assistance to the Licensor to enable him to comply with the obligations and formalities involved. (It may be advisable for the parties to specify who will bear the cost of the formalities for the payment of VAT, for example the necessity to have a fiscal representative, if such is applicable).

17 Marking

The Licensee shall mark all articles made by him/her under this Licence and supplied to his/her customers with serial numbers and shall affix to such articles a plaque inscribed "Licence: Licensor's name" or "Licence: trade mark".

18 Accounts and inspection of accounts

The Licensee shall keep a special register in which s/he shall record the exact number of items manufactured by virtue of this Agreement, the serial numbers marked on such articles, and any other information relevant for determining the amount of royalties payable. The Licensor shall have the right by means of an accountant appointed by him/her and approved by the Licensee (who shall not unreasonably withhold his/her approval) to inspect these registers and to examine whether they are consistent with the general accounts of the Licensee. The costs of such inspection and examination shall be borne by the Licensor.

19 Settlement of account and payment

19.1 Royalty accounts shall be rendered quarterly. The Licensee shall within a month after the expiration of each calendar quarter send to the Licensor a complete account and any sum due to the Licensor thereunder.

19.2 The Licensee shall pay the Licensor in the currency or currencies in which payment is due.

20 Obligation to exploit the Licence

20.1 The Licensee undertakes to exploit the Licence and not to manufacture or sell articles to compete with the items under this Licence.

20.2 If the Licensee shall have shown that the invention(s) on which the Licence is based has (have) lost its (their) market by reason of technical or economic developments, s/he shall be entitled to terminate this Agreement before its performance is complete.

21 Maintenance in force of patent

21.1 The Licensor is not obliged to keep in force all patents on which this Licence is based. If s/he decides to allow a patent to lapse, s/he shall inform the Licensee to this effect not less than six months before the date on which any steps necessary to keep the patent in force must be taken. Thereupon the Licensee shall be entitled to acquire the patent free of charge.

21.2 This Agreement shall in such event be deemed to have been terminated pro tanto to the extent of that patent on the aforesaid date.

21.3 So long as the Licensor shall keep the patent in force, the Licensee shall assist him/her by payment of the requisite renewal fees on the Licensor's behalf.

22 Protection of the patent

22.1 The Licensee shall take all reasonable steps to prevent the patents mentioned in the Recital being infringed on the territory for which the Licence is granted. The Licensee shall inform the Licensor of any such infringement which comes to his/her notice.

22.2 If the Licensee wishes to take proceedings against the infringer, the Licensor shall assist him/her, especially if the law of the territory in question makes such assistance necessary in the opinion of the Licensor. Unless the Licensor proceeds him/herself, s/he shall provide the Licensee with all powers and authorizations required to enable the Licensee to take such proceedings.

22.3 The party who decides to undertake legal proceedings shall bear the costs and enjoy the benefits therefor. If the parties agree to commence proceedings jointly, the costs and benefits thereof shall be divided as follows:

Licensor: 50 per cent
Licensee: 50 per cent

22.4 The Licensee shall not undertake proceedings or cause proceedings to be undertaken by another person for invalidating the patents underlying this Agreement or for attacking them on the grounds of subservience to a prior patent unless the invalidity is due to publication of the invention by the Licensor.

22.5 If the patent(s) underlying this Agreement is (are) revoked at the instance of a third party, the Licensor shall be entitled to retain any royalties already paid to him/her and to recover any royalties due at the date of revocation.

23 Duration of the agreement

23.1 This Agreement shall not enter into force until signed and until all authorizations required for its performance shall have been obtained, including any authorizations required for the transfer of currency.

23.2 The contract shall come to an end fifteen years from its entry into force.

23.3 Without prejudice to any express provisions for termination contained in this Agreement, this Agreement may be terminated for any cause sufficient to justify termination under the governing law of this Agreement.

24 Return of documents

24.1 The Licensee shall not, even after the expiration of the contract, communicate to third parties the Licensor's trade or manufacturing secrets. After the expiration of this Agreement, the Licensee shall cease using these and shall immediately return to the Licensor all documents relating to the manufacture of the items under this Licence.

25 Transitional provision

The Licensee shall be entitled to carry out after the expiration of this Agreement, contracts of sale entered into by him/her before the expiration of this Agreement.

26 Governing law

This Agreement shall be governed by the law of [country of FOREIGN].

27 Arbitration

27.1 Any disputes arising out of or in connection with this Agreement shall be settled without recourse to the courts, in accordance with the Rules of Conciliation and Arbitration of the International Chamber of Commerce, by one or more arbitrators designated in conformity with those rules, the award being final and binding.

27.2 The arbitrator or arbitrators shall have the power to rule on their own competence and on the validity of the agreement to submit to arbitration.

27.3 Either party may ask the competent tribunal to confirm an arbitration award or otherwise provide that it shall be enforceable.

IN WITNESS WHEREOF, the parties have caused this Agreement to be signed by their duly authorized representatives

[Place and date]

By ----------

(FOREIGN)

By ----------

(LOCAL)

Appendix G

Know-How Licensing Agreement[1]

Between FOREIGN, whose principal office is at [address], represented by [name and position], which is hereinafter called "the Licensor"

and

LOCAL, whose principal office is at [address], represented by [name and position], which is hereinafter called "the Licensee".

[1]The patent agreement provides the licensee with the right to use the patented items. The know-how agreement provides the licensee with the means and knowledge necessary to use them.

Recitals

WHEREAS the Licensor has been manufacturing the articles listed below for ten years:

[product 1] [description] …….....……

and

[product 2] [description] …….....……

WHEREAS these articles are protected in the following countries (list of countries and close description of intellectual property rights);

WHEREAS the Licensor has by Agreement with the Licensee dated ..... (which agreement is attached hereto and made a part hereof) authorized the Licensee to reproduce and to sell the [product1] and [product 2] with patents;

NOW, THEREFORE, in consideration of the mutual representations, warranties, covenants, and agreements herein contained, the Licensor and the Licensee agree as follows:

The Licensor agrees to furnish to the Licensee generally all data on the article and his/her experience and methods, including know-how or manufacturing secrets, so that a normally qualified technician can use them after a reasonable period of adaptation.

1 Provision of technical information

1.1 The Licensor shall furnish to the Licensee within one month of the signing of this Agreement and after payment of the sums mentioned in section 14 of the Foreign Patent Licence Agreement, all drawings and dimensional drawings enabling the article to be manufactured or used.

1.2 Such drawings shall be accompanied with a complete technical dossier including ……

1.3 Any drawings and documents furnished may not be used for purposes other than the performance of the Agreement without specific approval by the Licensor.

2 Technical assistance

2.1 The Licensor shall at the cost of the licensee as mentioned in section 14 of the Foreign Patent Licensing Agreement, furnish to the Licensee in good faith and without reservation all technical assistance and advice necessary for the use and exploitation of the inventions covered under this Agreement.

2.2 The Licensor shall provide the Licensee with the services of skilled personnel on the following terms and conditions:

2.2.1 Number and qualifications (including language skills) of personnel provided
2.2.2 Length of time for which loaned
2.2.3 Board and lodging
2.2.4 Responsibilities
2.2.5 Insurance
2.2.6 Cost and how to pay

2.3 The Licensor undertakes to instruct JOINT COMPANY employees to explain to them the manufacture of the items under this licence on the following terms and conditions:

2.3.1 Number and qualifications of employees to be instructed
2.3.2 Length of instruction
2.3.3 Responsibilities
2.3.4 Cost and how to pay

3 Responsibility for claims by third parties

3.1 The Licensor declares s/he has no knowledge of any valid patents belonging to third parties and covering devices or processes which form the subject of this agreement, but cannot warrant that such patents might not prove to exist.

3.2 If reproduction, sale or use of the article by the Licensee results in a claim for infringement against the Licensee, the costs and any damages awarded against him/her as well as the costs of any counter-claim or of settling a claim shall be borne as provided in the Foreign Patent Licence Agreement dated .....

4 Obligation to buy from the Licensor

4.1 For the manufacture of the items under this Licence, the Licensee undertakes to buy from the Licensor the following parts .....
.....

4.2 The said parts shall be supplied in accordance with the General Conditions annexed hereto, and the prices shall be the Licensor's catalogue prices at the relevant time. [2]

5 Confidentiality; post-expiry

The Licensee shall not, even after the expiration of the contract, communicate to third parties the Licensor's trade or manufacturing secrets.

6 Transitional provision

The Licensee shall be entitled to carry out after the expiration of the Agreement contracts of sale entered into by him/her before the expiration of this Agreement.

[2] If there are no catalogue prices, the parties must establish a list of prices and a method of revising them.

7 Governing law

This Agreement shall be governed by the low of [host country].

8 Arbitration

8.1 Any disputes arising out of or in connection with this Agreement shall be settled without recourse to the courts, in accordance with the Rules of Conciliation and Arbitration of the International Chamber of Commerce, by one or more arbitrators designated in conformity with those Rules, the award being final and binding.

8.2 The arbitrator or arbitrators shall have the power to rule their own competence and on the validity of the agreement to submit to arbitration.

8.3 Either party may ask the competent tribunal to confirm an arbitration award or otherwise provide that it shall be enforceable.

IN WITNESS WHEREOF, the parties have caused this agreement to be signed by their duly authorized representatives.

[Place and date]

By ----------

(FOREIGN)

By ----------

(LOCAL)

SAMPLE

LETTER OF INTENT
(OR MEMORANDUM OF UNDERSTANDING)

Example 1: Non-binding[3]

This is to put on record that the parties, which are hereinafter referred to as "First Party" and "Second Party", have met on ……., in ……., on the occasion of the Regional Forum for Promotion of Industrial Investment Projects organized by UNIDO.

Both parties have expressed their interest and intent to further explore a project in ……..... relating to ……..…… [description] …….

Within a period of two months from the date of this Letter of Intent both parties shall exchange further information concerning the above said project. Specifically, they shall do the following:

First Party …….

…… [action expected from First Party] …….....……

Second Party ……

…… [action expected from Second Party] …….....……

After the exchange of Information as described hereinabove, both parties shall decide on further steps to be undertaken.

If within two months from the date of this Letter of Intent parties did not reach an agreement on the future course of action, this Letter of Intent shall cease to be expressing the interest of the parties to develop the said project. In such a case neither of the parties has the right to claim any compensation on whatever ground for actions undertaken and/or work performed following the signature of this Letter of Intent.

The First Party
Represented by [name and position] …….....

Address ……...……

The Second Party
Represented by [name and position] …….....……

Address ……...……

[3] *See* section 3.4.4.

S A M P L E

LETTER OF INTENT
(OR MEMORANDUM OF UNDERSTANDING)

Example 2: Partly-binding[4]

First Party: ..... (represented by .....)

and

Second Party ..... (represented by ……)

Both Parties, after the meeting held during the UNIDO FORUM for Promotion of Industrial Investment Projects in ..... confirm herewith their intention to continue further discussions on the feasibility, terms and conditions of a prospective joint venture or other forms of industrial cooperation to be undertaken by both Parties in…….....

The following has been tentatively agreed upon:

1 Activities of a possible future joint venture will be in the field of .... ……..... (hereinafter referred to as "the Project");

2 Parties shall explore the appropriateness of the kind of investments (cash, technology, know-how, etc.) best suited for the possible future Project;

3 It is tentatively envisaged that the First Party shall hold ..... per cent and the Second Party ..... percent of the equity;

4 Both parties shall undertake the following preparatory activities necessary for the implementation of the Project:

First Party shall:

(a) Elaborate a feasibility study (Pre-feasibility study) of the Project taking into consideration all the relevant facts and circumstances;
(b) If the feasibility study (Pre-feasibility study) shows a potential for development of the Project, elaborate a draft of a Joint Venture Agreement (or a draft outline of a Joint Venture Agreement);
(c) submit the documents under *(a)* and *(b)* above to the Second Party within ..... months from the Letter of Understanding;

[4] *See* section 3.4.4.

Second Party:

(d) Clarify all the relevant conditions for the implementation of the Project Agreement in the country where the Project will have its seat, including all the relevant procedures and requirements for the establishment and registration of a Joint Venture Company;

(e) Help the First Party in the elaboration of the documents under *(a)*, *(b)*, and *(c)* hereinabove, including procurement of necessary available data, designs, studies, already made or otherwise available in connection with the Project;

5 Both Parties undertake that they shall consider all data received by the other party as confidential and shall not be released or divulged to any other third party;

6 All the above under 4. shall be accomplished within ……months from the date of this Letter of Intent;

7 Each Party is entitled to withdraw at any time from further negotiations, after the accomplishment of the undertakings under 1-6 of the Letter of Intent;

8 In case of such withdrawal neither party shall have the right to claim damages, compensation or any other kind of reimbursement for the costs incurred in performance of the above said undertakings;

9 However, if the feasibility study under 4*(a)* hereinabove (not the pre-feasibility study) shows that the Project would be an economically viable proposition giving a fair return on invested capital, and the other party nevertheless withdraws from further negotiations, such withdrawing party shall be obliged to cover half of the cost of the said feasibility study (but in any case not more than $US ……..).

10 All disputes arising our of this Letter of Intent shall be finally settled by arbitration under the Rules of Conciliation and Arbitration of the …… ……..... in …….....
The law of …….. shall be applicable.

The First Party
Represented by [name and position] …….....……

Address …….....……

The Second Party
Represented by [name and position] …….....……

Address …….....……

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