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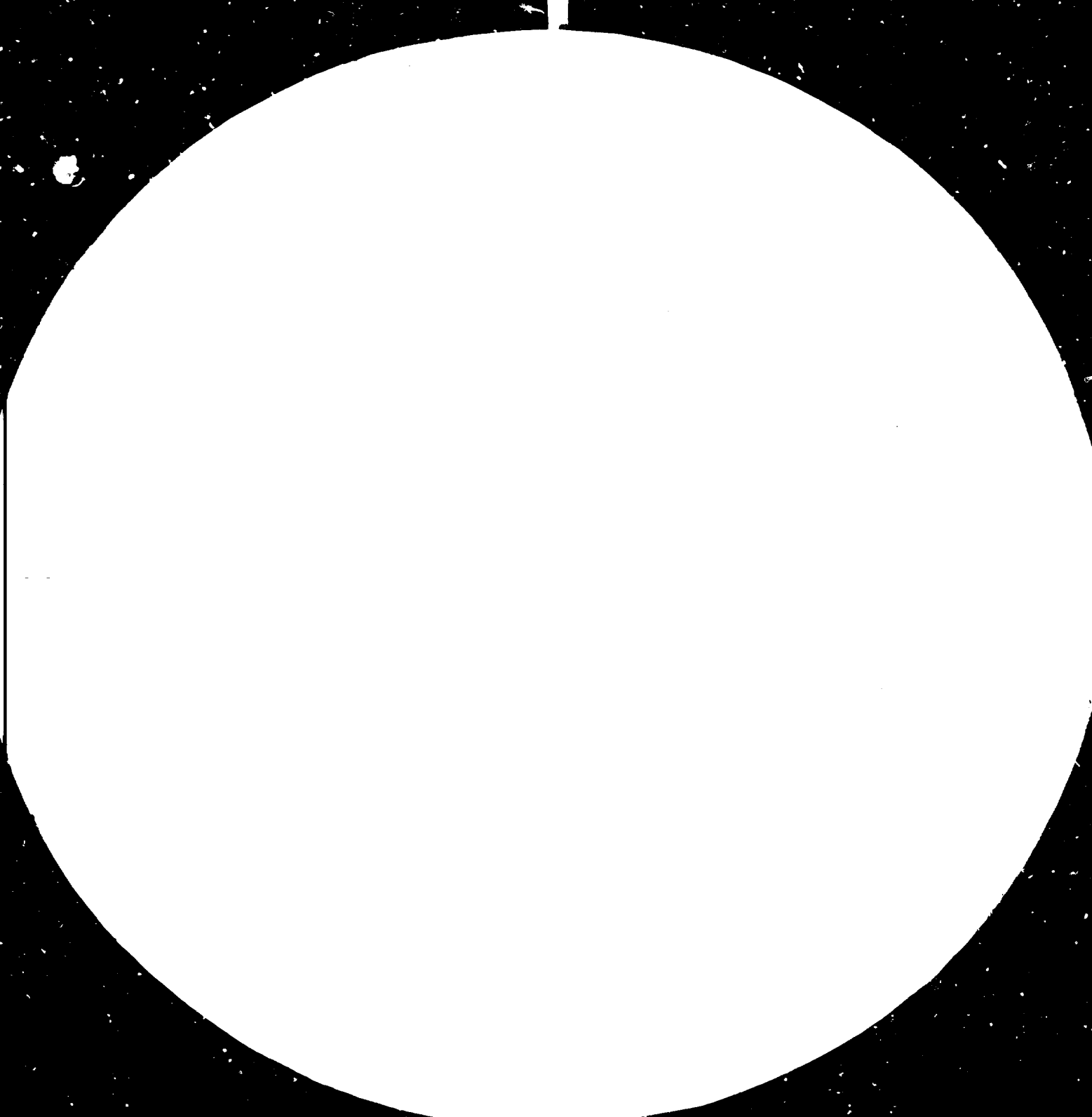
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GUIDELINES FOR THE ESTABLISHMENT OF INDUSTRIAL
JOINT VENTURES IN DEVELOPING COUNTRIES*

prepared by

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* This is an advance edition of a UNIDO publication to appear in the Development and Transfer of Technology series. The views expressed in this paper are those of the author and do not necessarily reflect the views of the secretariat of UNIDO.

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INTRODUCTION

The Joint-Venture in National Perspective

The industrial joint-venture concept, in its modern developing country form, firstly and basically reflects an evolving compromise of opposing principles and systems effecting link resources, markets and institutions. Secondly, it is a manifestation of interdependency in a growing inter-related world. For the developed countries, the joint venture is emerging as a viable instrument for obtaining access to raw materials, low-cost manpower and markets without dominating political control. For the investing corporations, 'presence' in the regions of the fastest growing markets is an important contributory factor. For the developing countries, the joint venture is beginning to emerge as an institution of substance, controllably responsive to immediate environments, without being a foreign base from which a foreign firm carries on its normal operating and financial functions.

In the compromise, what seems to be sacrificed - if indeed there is a sacrifice - is some element in the 'privateness' of private foreign investment, and for the

developing country, the need to explicitly scission the linkage between capital and technology.

Developing country governments are interested in the gain, and maximising the gain, of the industrial enterprise to which they make many concessions, often in priority to other claims. Ventures with private foreign investment are promoted in the hope that technology will effectively improve efficiencies in the use of national inputs and that manufacturing operations will increase, interlink and diversify the flow of goods. It is postulated that when the foreign partner brings capital and technology to an enterprise he will so influence or manage the composite that it yields him the highest financial or other economic advantage. This effort, it is believed, directly and indirectly benefits the national technological structure by requiring technology to be applied in a manner which is appropriate to the environment.

Relative to the gain of the enterprise, governments have three important objectives. First, the gain should primarily take place in activities economically beneficial to the nation. Second, gain, and its division among its promoters, should prima facie arise from manufacturing and marketing operations and not from peripheral contributions of the promoters, such as patent grants, the rendering of services, sales of inputs or exclusive marketing rights.

Third, in the division of the gain, the national promoter should in some manner - such as proportionated stock holding - be compensated for his intangible contributions, among which may be the bringing of the national market to the joint venture, serving as organiser of domestic inputs, exercising his influence with the national business community, etc - all of which may be no less real than trademarks or knowhow.

Increasingly, developing country governments aspire to attain these objectives through national investment laws and the regulation of technology. Recognising, however, the nature of the international technology market, and, in particular, technology-associated capital flows, enlightened legislations permit, to the extent that is feasible, a free determination of the working relationship between the partners to the enterprise. In this process, developing countries are prepared to endorse incentive remuneration for efficient combinations of capital and technology and acquiesce in the providing of reasonable safeguards to foreign investment.

While the modern industrial joint venture is a creature of developed and developing countries interacting in the macroeconomic system, and is subject to the influence of socio-political institutions in both the developed and

developing countries, it needs to be recognised that it is an organisation which fundamentally reflects the private interests and private compromise of those who freely elect to associate with each other.

The Joint-Venture in the Promoter's Perspective

While national policies (such as legislation prohibiting the setting up of wholly-owned foreign subsidiaries; high taxation of profits of wholly-owned subsidiaries; the erection of barriers on transfer of funds from subsidiaries to parent companies; encouraging capitalisation of technology, etc) have in the past, partly led to the adoption of the joint-venture instrument in developing countries, the joint venture basically emerges from one of three propulsive elements: (1) the national entrepreneur demonstrating to the foreign partner the viability of a particular investment opportunity (2) reversibly, the foreign firm finding a suitable national partner to exploit an attractive resource or market situation and (3) the business and corporate policies of a particular foreign firm in relation to the licensing of its technology.

The rationale for the joint-venture relationship varies with the promoter's perspective.

A. From the perspective of the national partner who seeks out a foreign partner, the rationale may be:

(i) investment from the foreign owner of technology implies acceptance of market risks and provides the insurance that the technology applied would be relevant to the purposes of the venture and appropriate to the market place

(ii) the investment of capital would bring with it both management and access to markets (over which the foreign partner has trading influence or authority)

(iii) the overseas investor becomes, from the viewpoint of protecting his investment, a reliable long-term source of those raw materials and inputs over which he has control

(iv) likewise, the association provides assurances for the continuity and competitive viability of the enterprise by the access it obtains to the foreign investor's R & D - particularly 'process and product improvements' and international 'market intelligence'.

B. For the foreign firm which seeks a national joint venture, the motivations may be:

(i) obtaining access to developing country markets

(ii) a means to shift production sites from a high-cost environment to one of lower cost, or to reduce overall

business risk through geographic dispersion of manufacturing operations

(iii) to use the national partner to support the venture with national inputs such as labour, raw materials and working capital; to reduce risk capital outlay by using national partner's inputs; to obtain access to low-cost institutional funds available to developing country firms

(iv) the possibility of capitalising supplies and services; etc.

C. Features that lead to joint ventures as a resultant of a foreign firm's operational philosophies are:

(i) it is the firm's policy to be in the 'business' of marketing products and not technology; thus, that technology itself is not available for sale or license

(ii) business direction that the joint venture will be the sole vehicle through which the firm will offer technology internationally

(iii) the view that returns on technology are too small in contrast to opportunities for direct investment

(iv) the impression (erroneous) that national policies of developing countries imply expropriation of technology after a period of time if it is not controlled through capital, etc.

For the promoters who come together to form a joint venture, the 'gain of the enterprise' - its national economic contribution - may be an abstract concept. For them the yield on investment, stability of income and the security of property would be of prime concern. It is possible that the national enterprise may merely be a vehicle by which they otherwise achieve their 'personal', subjective aspirations. Thus, the arrangements the promoters will tend to make among themselves will be oriented to their relative rights, influence and authority in the structure, management and the profits of the enterprise. The promoter who has the higher capacity or stature to influence the performance of the enterprise can be expected to seek in it a superior or controlling position.

In sophisticated industrial economies, indeed, the structure of the joint venture enterprise and the rules by which it will be governed, are determined, almost solely, by the partners considering such facets. So long as the founders of an enterprise do not act, or contract to act, to the detriment of 'public interest' (or to the 'public' that contributes to the firm's capital), national legislation - by implication - gives them every right to determine their working relationship and rewards.

The Developing Country Perspective : Government Intervention

In the context of the developing country, the government becomes a 'third party' to the establishment of a joint venture. Governmental intervention principally arises from two considerations: (a) developing country experience that joint ventures tend to be organised sub-optimally, negatively influencing both the 'gain of the enterprise' and the role of the national partner and (b) as a corrective to the situation that with much of technology being in a 'sellers' market, the national partner is often placed in a disproportionately adverse bargaining position, and consequently, that government should intervene to strengthen his position.

Governmental intervention is manifested by the influence it exercises in approving, what is in its point of view; (i) appropriate business objectives - via laws relating to the establishment of industries (ii) appropriate technology and resources - laws relating to the licensing of technology and (iii) appropriate partner relationship laws relating to foreign investment and the incorporation of national companies.

In consequence, the promoter in the developing country does not have the full freedom to dimension his relationship - to find his equation - with the overseas co-investor.

For example, he will not be able to agree with his co-investor, without the concurrence of a national statutory authority, that the value of the technology to be imported is 'x' million dollars, or likewise, to contractually accept that the overseas partner can 'capitalise' all of the value of this technology so as to form a part of the latter's equity in the national company. At the same time, however, the national entrepreneur may have full liberty - full option under national legislation - to transact the specifications and quantities of the product to be manufactured; the type of technology to be applied; the financial structure of the enterprise (the debt/equity ratio); the rights of the overseas investor in the decision-making apparatus of the enterprise; the methods of taking decisions in certain critical areas, etc.

Options of the National Entrepreneur

The concept of 'options' available to the national entrepreneur does not imply that some mechanism will be at work which sharply demarcates those options which are open to him and those which are reserved for the regulatory body of the developing country. Invariably, there will be a 'grey area' of options - its width varying with national situations - which allows for organisational and contractual flexibility. This grey area is often

an intended one and can bring benefit both to the country and to the entrepreneur.

An entrepreneur intending to be efficient in his contractual relationships with his foreign partner must, thus, appreciate national legislative directions, the options which are directly exercisable by him and the ambivalence of the grey area.

The successful joint venture is not created by the contract which sets out the options exercised by the partners.

It is created by the strength of common purpose and by the rationale which underscores its existence. However, since the capacities and capabilities of those who create the common purpose will generally be unequal and different, each partner may not be able to reap the same benefit from the enterprise as the other or to hold equal sway in its decisions. It is in these latter areas that the contractual relationship becomes important.

This monograph is addressed to the entrepreneur in the developing country who is investigating possibilities of entering into a joint-venture relationship with expatriate investors. The monograph first seeks to establish methodology by which a national entrepreneur can pursue an investment opportunity and find a potential partner. Second, on the basis of such identification, this monograph attempts to

discuss, in some detail, the variations possible in contractual relationships. In the latter context, this monograph can also be seen as a tool aimed to strengthen the bargaining capacity of the national entrepreneur. It is pointed that the entrepreneur is strengthened when he: (i) has a fairly precise concept of what he wishes the enterprise to accomplish (ii) has clearly prepared the groundwork for meeting potential foreign partners and (iii) has the knowledge of the implications arising from the exercise of options open to him.

Because of the considerable complexities in establishing a joint venture, particularly in the developing country context, it is not feasible to discuss all of its aspects. Fortunately, entrepreneurs have access to several UNIDO publications which treat, at some length, particular aspects in the setting up of industrial ventures in developing countries. Of these, four need to be mentioned and recommended: (i) Manual for the Preparation of Industrial Feasibility Studies (ID/206) (ii) Guidelines for Contracting for Industrial Projects in Developing Countries (ID/149) (iii) Guidelines for Evaluation of Transfer of Technology Agreements (ID/233) and (iv) Manual on the Establishment of Industrial Joint-venture agreement in Developing Countries (ID/68). This last publication is concerned with contractual clauses in joint-venture agreements.

This monograph fills a gap in the above mentioned set of publications: a discussion of the issues that are commonly raised and sorted out among partners before they set down the terms of their compromise in contractual formats. However, even to this extent, there is a limitation: the legal, economic and technical parameters that relate to the acquisition of technology - knowhow, patents, trademarks and other 'industrial property' rights - which are undoubtedly important issues in the process of joint-venture negotiation, are omitted. This has been done because a recent UNIDO publication (ID/233) adequately covers this area.

Except for footnoted references to ID/233 in terms of matters concerning technology licensing, this monograph approaches the issues of joint-venture formation without the requirement that its reader keep referring to the companion publications.

The monograph basically comprises of three parts: (a) the preparatory work a national entrepreneur must do before he approaches expatriate investors (b) the most important issues that have to be resolved among the partners before a joint-venture agreement is written and (c) the general developing country legislative framework in the context of which the joint venture is finally approved by

national governments. The 'heart' of this monograph, and its most important contribution, lies in the last four sections, three of them concerning negotiations on capital, management and technology, and the fourth, the general structure of the final joint-venture agreement.

It is hoped that this monograph will provide sufficient background for an entrepreneur inexperienced in the flotation of joint ventures to confidently seek foreign collaboration. However, it will not enable a reader to become an entrepreneur!

This monograph has the limitation that it does not proceed beyond the stage of the incorporation of the joint venture. It does not cover the important area of post-incorporation activities such as the contracting of plant construction, the establishment of domestic and export marketing networks, purchase and product promotion strategies, production planning, the manning of the organisation, its policy framework, manpower development, etc. Also omitted are considerations relating to the composition of teams which would best negotiate the joint venture and the strategies and dynamics of inter-personnel interactions in joint-venture negotiation.

The Joint-Venture Concept

The joint venture discussed in this monograph is the 'industrial joint venture' involving substantive use of overseas technology; generally established between corporate entities in developed and developing countries; and operating under the national legislative framework of the developing country. While the joint-venture company discussed is a 'joint-stock' company, it differs from the usual joint-stock company in that its members/founders are primarily corporations (themselves companies) rather than the lay public.

While many variations are possible, the joint venture can basically take one of two forms: (I) the joint venture formed by the specific incorporation of a company, with the company acting as the vehicle for achieving the purposes sought by its founding corporations, (II) the joint venture formed 'by agreement'. In the latter form, two or more existing companies establish a 'joint venture' which essentially is an arrangement to carry out a particular type of activity, without creating an entity with legal corporate identity. For example, three companies incorporated in, say, three different countries, can "by agreement" undertake a joint venture to market a product which will be: produced by Company A, financed (via working capital) by Company B and marketed through the

distribution channels of Company C. Alternatively, a Company D in a joint-venture agreement with Company E can arrange to employ the plant facilities of E and the technology of D to produce and market a product whose quantum of production is shared between the companies (so-called 'co-production' agreements). Yet again, two companies can 'pool' their assets in a joint venture to manufacture a product (say, the petrochemical raw material intermediate, ethylene) and by agreement, use it in some ratio in (their) separately owned enterprises. In these latter forms of the 'joint venture', division of profit, expenses, production, etc will be arrived at by some formula set down in the agreement. In other words, unlike the situation with the incorporated joint-venture company, division of profit is not determined by respective contributions to equity funds. Also, a common legislative framework need not govern the operations of the collaborating companies.

While the 'joint venture by agreement' could be an important instrument for industrialising developing countries, and is particularly amenable to exploitation by inter-governmental agencies, it is not a subject of this monograph.

The joint venture considered in this monograph has the following characteristics^{1/}. It is:

- (a) a separately incorporated enterprise in which
- (b) investors from two or more countries
- (c) commit capital and/or technological assets
- (d) share some degree of management
- (e) participate jointly in all risks of the enterprise, and
- (f) share in the net earnings in the ratio of their contributions to the equity of the enterprise.

In order to highlight issues of competing self-interests and potential conflict, the model joint venture of this monograph is a 'two body' or 'two shareholder' enterprise, with both the bodies, as already stated, being corporate entities. The issues discussed admit of 'third body' involvement as would happen in 'third country' ventures or when governments and banks provide equity capital to an industrial firm.

^{1/}Modified from 'Joint Ventures and Public Enterprises in Developing Countries' Proceedings of an International Seminar held in Ljubljana, Yugoslavia, 4-12 December, 1979. Published by International Centre for Public Enterprise in Developing Countries, Ljubljana, Editor V.V. Ramanadham, (1980).

In many developing countries, particularly in the incipient stages of development when there is a paucity of entrepreneurs, joint-venture companies are often established by 'family companies'; that is, companies floated by publicly well known family groups (of the developing country). In other cases, with the experience of Singapore being illustrative, a national company with some level of government stock holding and management may initiate a joint-venture company for eventual 'spin-off' to private investors. In yet another instance, the case of Egypt perhaps being illustrative, a joint venture 'by agreement' may be initiated by a public sector agency for eventual spin-off into an incorporated joint venture in which the agency has equity holding. Or again, a national company may be invited by the wholly-owned subsidiary of a transnational corporation to participate with it in a joint-venture company. This monograph is addressed to such national entities.

While there is some discussion on joint ventures involving the participation of the public stock holder, greater emphasis is placed on discussing aspects pertaining to the protection of minority shareholder interests (the 'public' seen as such a shareholder) rather than on the issues of using large quantum of public capital in enterprises via the stock market mechanism. Nevertheless, the discussion pays due regard to the objectives of most developing countries to broadbase corporate ownership by capital diffusion.

Under the maximisation/minimisation principles of economic literature, the theoretical attractiveness of the joint venture is that a combination of the unique contributions and strengths of the partners has a synergistic effect: the risk of the enterprise is lower than what might prevail if either of the partners was to solely establish it. However, in many joint ventures, as is well known, the national partner is merely a 'sleeping partner', content to find a means of putting his money to work and unconcerned with risk minimisation. At the same time, a national promoter, who aspires to have an active role in risk management, may ultimately find that, for certain reasons, his joint-venture project has reduced him to the status of the sleeping partner. This monograph attempts to probe areas and issues which would thwart such a situation.

The important assumption is made, which tacitly or expressly underlies all discussion, that the developing country firm is fundamentally seeking, in its efforts to find a partner, a source of technology and not that of capital; that foreign capital becomes associated with the enterprise because of an ancillary need of the enterprise, as an assurance for the performance of the technology, as a condition of the foreign firm's terms for the supply of technology, etc. This assumption is consistent with developing country policies towards direct foreign investment.

In the sequence of discussion, it will be seen that the national entity attempting to found an enterprise undergoes many transformations. It begins, in its role as 'entrepreneur', exploring and identifying an investment opportunity; increasingly it becomes a 'promoter' establishing the attractiveness of the opportunity to foreign investors; then with the willing foreign investor it becomes a 'partner'; and finally, with the venture launched, it is, at one level, a 'shareholder', and at another, a 'manager'. In order to show this progression, and also the multiple roles assumed by the national entity, this monograph avoids the use of a single constant term to define the national entity. In the last four sections, the dualistic role of the investors as shareholders and managers is considered in some detail.

As will be repeatedly stressed, joint-venture arrangements are made in the context of a legislative environment, and hence, the influence of the latter on business options must be recognised. To permit discussion, a generalised form of developing country legislation is assumed, biased to the laws of incorporation of countries following (generally) the English system. However, in Sections II and III, the attention of the reader is drawn to variations in the laws of some developing countries. While the attempt has been made to be 'current', some statutory provisions

may have changed in the recent past. The reader should not place too much emphasis on illustrative case material drawn from different countries. In a monograph oriented to providing guidelines, the general framework is more important than the particular.

To the extent that a 'company' is a creature of law, the joint venture cannot be discussed without some reference to law. However, every attempt is made to minimise or avoid discussion of purely legal issues. The reader is not required to have a legal background.

Some new quantitative techniques for the evaluation of technology alternatives (Section I) and for the determination of 'national venture partner's share of enterprise income' (Section V) are presented because experience has shown that developing country entrepreneurs are particularly concerned with evaluations in this area. However, it is recommended that the techniques be used to supplement conventional methods of analysis.

This monograph, commissioned by UNIDO, is primarily based on the experience of its principal author, Dr. Venkata R.S. Arni as a UNIDO Consultant with governmental departments of several developing countries, on information and experience gained by him in international seminars and

meetings organised by UNIDO, on case studies of joint ventures that he has prepared for international organisations, among which is the UN Centre for Transnational Corporations (UNCTC, New York) and finally his professional experience with a transnational corporation with substantial public capital operating highly diversified manufacturing operations in a developing country. The author has constantly consulted with the UNIDO Secretariat on all substantive aspects of this publication and greatly relied on the personal assistance, guidance and contribution of UNIDO staff.

During the preparation of this monograph the author met with the representatives of private joint-venture companies, national regulatory bodies in Spain and Singapore, and with eminent legal firms and personalities in the latter two countries and in India. The knowledge gained from the meetings is reflected in the analytical material of this monograph.

SECTION I

PROJECT AND TECHNOLOGY SELECTION

Overall Framework

Between the stages of becoming aware of an investment opportunity and the formation of a joint-venture company to realise that opportunity, it is possible to visualise a series of sequential operations. This is depicted in Figure 1. Each operation or step involves the analysis of information, alternatives and a decision. A favourable decision would lead to the next step. In the situation of most developing countries, steps immediately precedent to the establishment of the joint venture (steps 10-13) and the establishment step itself (step 14), require the approval or endorsement of governmental bodies of the host country. Thus, there is 'third party' intervention in key decisions. In some countries, host country governments may influence decisions, directly or indirectly, even at the early stages of a project. Thus, the Government of India, through its procedures of 'industrial licensing' (industry permits) may not 'license' an entrepreneur to establish a manufacturing facility if, in its opinion, there is excessive capacity

FIGURE I

Formation of a joint-venture company -
a series of sequential operations

- | | | | |
|---|---|---|--|
| (1)
Indentification
of investment
opportunity | (2)
Market survey | (3)
Pre-investment
studies | |
| (4)
preliminary
definition
of project | (5)
technology
alternatives | (6)
search for joint-
venture partners | |
| (7)
Selection of
technology | (8)
Selection of
joint-venture
partner | (9)
Detailed project
studies | |
| (10)
definition of
project and
form of joint-
venture
organisation | (11)
draft joint
venture,
technology and
services
agreements | (12)
proposals
to host
country
government | (13)
Host country
approvals |
| (14)
Joint-venture
incorporation | (15)
Project finan-
cing | (16)
Execution
of agree-
ments | (17)
Impiementa-
tion of
project. |

in the country for the intended product; likewise, in Mexico, a private sector firm may be debarred, through legislation, from establishing an upstream petrochemical project even if there is unfilled capacity, etc.

The taking of a decision at any step implies acceptance of the risk inherent at that step. For instance, a market survey may indicate that prices for a product, on the worst assumption, may decline by 20% over a period of five years. The entrepreneur must assess the acceptability of this risk and then proceed. Likewise, inflation may drive up the cost of a project by more than the estimated level and endanger projected profitability. Similarly, in a choice of two potential joint-venture partners, the more dynamic partner may have poorer knowledge of the economics of a developing country than the other conservative partner. And so on.

A whole range of such risks can often be minimised by utilising the experience of the overseas joint-venture partner: by involving him in the decision-making process. This would be desirable. However, the set of risks that arise in choosing the joint-venture partner, per se, and setting out the terms of the collaboration, must be assumed by the national entrepreneur.

Consequently, the sequential process shown in Figure 1, which shows that the overseas partner is chosen after the national entrepreneur has done some 'homework', is not truly sequential. There would often be forward and backward reassessments. In practice, the national entrepreneur, alone, or through the use of consultants, would follow the indicated steps up to the stage of meeting potential partners. Then, using the potential partners (if feasible, more than one) he would reassess decisions made for the earlier stages. Depending on the outcome of this, and the entrepreneur's preference to one of the contending partners, he would then go forward towards the establishing the joint-venture facility.

As the objective of this Monograph is to largely discuss key aspects in the formation of the joint-venture company - essentially steps (6), (8), (10), (11) and (14) of Figure 1, it is not feasible to be comprehensive on the techniques employed for assessing the viability of projects^{2/}, the selection of technology or of project funding (except to the extent that they directly bear on joint-venture negotiations). In what follows, key features, in abbreviated form, are presented for the procedures that range outside the purview of this Monograph.

^{2/} See Publications:

- Guidelines for Project Evaluation, Sales No.E-72-II.B.II U.N.(1972).
- Guidelines for Contracting for Industrial Projects in Developing Countries Sales No.E.75.II.B.3 U.N.(1975)
- Manual for the Preparation of Industrial Feasibility Studies, Sales No.E.75.II.B.5 UN(1978).

Identification of Investment Opportunity

In developing countries opportunities for industrial investment are often identified by considering financial incentives offered by national Governments to firms which will engage in various essential activities: import substitution, utilisation of national resources, exports, strategic preparedness (defence industry goods), etc. The equivalent opportunity to fulfil 'latent' or 'hidden' consumer needs, which is an important force for innovation and investment in the industrialised market-economy countries, would generally be absent.

Governments of developing countries are cognisant of the fact that a climate for investment (private sector investment) can be made to prevail only in a structured environment. This is one which artificially raises product prices (over international levels), lowers costs of manufacturing inputs, enhances profitability, etc. Environments are structured by a variety of measures such as import tariffs, import quotas, subsidised inputs (power, fuels), government-financed infrastructures ('industrial estates'), market segmentation ('reserved industries' for the small-scale sector, as in India), low-cost loans, low tax rates etc. Some of these mechanisms also 'transfer' investments from traditional channels (as banking, trade, etc) to the supply of goods and technical services.

With this perspective, it becomes possible to itemise those factors an entrepreneur needs to consider (and evaluate) at the stage of recognising investment opportunities:

- a. the volume of imports in the selected area
- b. available tariff protection (customs duties, import quotas)
- c. important suppliers of the product to the national area
- d. the relevance of trademarks in gaining consumer acceptance
- e. existing national producers of products, if any, and their general standing
- f. available government incentives for investment, importantly tax incentives
- g. the suitability of supporting infrastructure (rail, links, stability of power, leasability of land/buildings, etc)
- h. probable level of investment needed (by reviewing supplier company balance sheets)
- i. a general idea of raw materials or components needed for manufacture and their national/international availability
- j. general availability of skilled manpower
- k. government policies for the encouragement of the specific industry of which the product would be a sub-group

1. potential for export of the intended product,
etc.

At the stage of 'investment awareness' the entrepreneur is largely involved in qualitative assessments. At this point no assessment can be made of risk except to the realisation that he will be diverting his funds from their normal stable employment to a new area. Risk, to the extent it can be surmised, would be minimised if the entrepreneur has been a trader in the intended line or closely associated with its trade.

At the awareness stage, the entrepreneur would largely be working on his own and without the involvement of consultants, etc. He would be incurring only minor costs. He would be free of accepting or creating obligations.

THE MARKET SURVEY STAGE

If the entrepreneur finds from his investigation of the above listed factors that an investment opportunity exists, he would normally undertake a market survey - a survey which defines the conditions of the market place and which analyses the growth potential for the intended product.

In the situation of the developing country, as experience in India or the Philippines amply indicates, local

production, by creating immediate accessibility often rapidly escalates internal demand. That is, local consumption escalates much faster than what can be expected from extra-polating import trends. This is because downstream investments, which depend on local availability of the product, take place.

However, the actual realisation of the larger market does not immediately follow from mere production. The entrepreneur would have to establish a product distribution and servicing network: by himself, by utilising existing marketing channels for the product, or by indenting upon an existing distribution chain handling a related line of products. If there is a competitive producer in the national territory, then the asset and competitive viability of the latter's distribution system would need to be evaluated.

Because of the small size of markets in developing countries, particularly when the production of a product is incepted, costs of production (and distribution) would generally be so high as to put significant pressure on profitability. Volumetric growth alone would permit a rational decline in costs. Consequently, an investment opportunity becomes viable only when there is the assurance of market growth.

Thus, the purpose of a market survey is to: define the structure and economics of the market place for an intended product; to estimate probabilities of its growth; and to determine the scope available to the entrepreneur to participate in the growth.

Later, when potential overseas venture partners are met with, the market survey will become a vital input to establish the initial size of the investment facility and to establish the degree to which it can be back-integrated ('production phasing').

For the carrying out of the market survey, particularly for a product with which the entrepreneur may be unfamiliar, it may be necessary to employ consultants. Either the consultant firm can be asked to define the 'terms of reference' of the survey, or the entrepreneur may define them. Often checklists given in marketing journals - for industrial goods, consumer products, industrial or consumer services - may be followed. In the circumstances of a developing country, local consultants may not have all the skills required for the survey; on the other hand, the use of foreign consultants may involve too high a cost. It would thus be usual for the entrepreneur to maintain a constant dialogue with local consultants as they gather and analyse data.

Forecasting Techniques

Techniques for demand forecasting vary from the simple to the complex. The choice depends on: (i) the nature of the product - whether it is an 'industrial' or 'consumer' product (ii) the availability and credibility of historical data and its degree of detail - in respect of both the product concerned and the general economy (iii) the expense that can be borne by the enterprise to collect and analyse production/consumption information and (iv) the skill of the forecasters. In the developing country context, forecasts for some industrial products, like automobile transmission systems or industrial chemicals (eg vinyl chloride) may be relatively simple; there may be a listable level of present and future users. The problem gets more complicated as products become simpler - like, say, steel wire or nuts and bolts - or have a diversity of usage - like, say, ball bearings or sulphuric acid. Forecasting becomes most difficult, and predictions more vulnerable, as one approaches consumer products; durables, such as refrigerators, or consumables, such as toothpaste or plastic bags. This is because forecasts are arrived at by 'sampling' users and by using statistical methods for analysis.

Within the confines of this monograph, it is not possible to illustrate quantitative methodologies. UNIDO publication

ID/206 refers to some of them. However, the following itemises the main methods:

A. The End Use Method: This simple method requires good current and future trend data on the users of a product. To use the method, the following must be independently known:

- (a) all users by user-category
- (b) consumption coefficients; for example, litres of fuel per year for a car, truck, tractor, etc if the forecast is one of fuel demand; and
- (c) growth forecasts of users.

B. Time-Trend Analysis: This method projects past consumption data. For example, if the consumption of product 'X' is known for the past ten years, it is possible to forecast future consumption on the assumption the trend will hold. If the graph of past data shows wide scatter of data, regression analysis can be applied (which will also provide an estimate of the reliability of the forecast) to obtain a simple forecasting equation.

C. Correlated Demand Forecasts: This method forecasts the future trend of a product by examining its relationship with a dependent or independent economic variable. For

example, the consumption of cigarettes is likely to depend on 'disposable income' of the population. In many countries, responsible agencies forecast 'disposable income' by using sophisticated economic models. The forecaster would then examine the historical association between cigarette consumption and such 'disposable income' data (that is, its correlatability in terms of a mathematical equation) and then using future forecasts of this income, project the sales of cigarettes. Alternatively, there may be strong correlation between cigarettes and writing paper without there being a casual relationship between the two. The forecaster can then work out the correlation equation using writing paper as the independent economic variable.

Often, these methods are used simultaneously to check out if there is consensus among them. All of the methods discussed above can only indicate 'long term' trends. It is expressly recognised that over short periods actual consumption can be strongly deviant. Only 'econometric' methods can reasonably forecast short-term trends and will require the use of computers.

Checklist for Market Survey

The following is a listing of the important features that a market survey should show up:

The structure of the market

- a. local producers (if any); production capacities and levels of production, sub-classifications of the product
- b. level of imports and sources of supply (overseas suppliers); importers
- c. size of the present market
- d. main geographic consumption centres
- e. market prices for various sub-classifications of the product (say, for a drycell line, prices for various sizes of batteries relative to their packaging-cartons, cases, etc)
- f. overseas market prices, cif prices and import tariffs/quotas
- g. distribution channels used by local producers and overseas suppliers; important wholesalers and retailers; ownership patterns of wholesale and retail agencies; stocking locations of wholesalers
- h. commissions and discounts paid to wholesalers and retailers
- i. modes of shipment of goods - truck, rail, air, etc and relative volumes handled by each mode; freight structure

- j. important trademarks and brandnames in the market place and division of the market by trademarks
- k. end-use applications for industrial products (say, for polyethylene resin, the percentage division of the market into injection-moulded goods, extrusions, etc)
- l. competitive products and division of market arising therefrom (very important for paints, drugs, etc); quality assessments
- m. exports made by local producers; direction of exports; export subsidies and prices
- n. technical service networks, available or employed in support of sales networks; modes of operation
- o. taxes and duties in industry
- p. national standards/industry specifications applicable in the marketing of the product, etc.

Projected Size of the market and market share

- a. projections relating to the general national economic structure: national and per-capita incomes, historical and projected; disposable incomes; historical and projected growth rates of industry, in general, and of the industry in which intended product is a sub-group

- b. historical growth of the market through imports and local production
- c. the share of importers and of local producers in the present market
- d. government policies on future imports and exports
- e. regional growth rates; fast-moving regions
- f. quantitative accessibility to export markets (and to export subcontracts)
- g. assessments of available share of market (to the entrepreneur); present and forecasted
- h. price-volume sensitivities and the market volume attainable by the entrepreneur for various levels of assumed prices, etc.

In effect, the 'structural' study of the market furnishes information as to how the entrepreneur will need to organise his production and sales structures, and the size-of-market study estimates the share of the market the entrepreneur can hope to achieve (in the forecast period) and what might be his probable production capacity. (It is obvious that, in the situation of markets in developing countries, a production unit will be sized to

meet demand at a targeted future date rather than to meet current available opportunity).

Unlike the information analysed by the entrepreneur at the 'awareness' stage, which is qualitative, the market survey stage yields quantitative information. However, this would not be 'hard' information like in the case of 'costs of production' (discussed shortly). By sampling errors, incorrect assumptions, market misreadings, deficiencies in projection techniques, etc a substantial level of risk is inherent in accepting - and working with - market survey findings.

While, as said earlier, a review of market findings in association with a potential joint-venture partner may lead to a better appreciation of the risk, risk can often only be minimised by becoming conservative on the market opportunity - that is, establishing a smaller production facility than what the survey indicates. This would generally increase unit production costs, downgrade profitability and disenchant the potential foreign venture partner. The latter may, in such a circumstances only put in a modicum of investment, if at all. (It will be seen later that such assessment of risks, risks measured differently by the partners, influences the ratio of equity holdings in a joint-venture undertaking).

The market survey generally does not furnish a clue as to the viability - the profitability - of a project. An exceptional situation can be one in which an existing producer (in the national scene) is known to be successful at a capacity level at or below that available to the new entrepreneur. Another situation may be one in which there is subcontracted production (assured market) with a cost structure known in advance.

A feasibility study is normally required to assess project viability and profitability.

PRE-INVESTMENT STUDIES

The market survey and the pre-feasibility study are usually regarded as pre-investment studies. A full-fledged feasibility study requires a great deal of technical and cost information and it is best undertaken in association with the joint-venture partner. It is also an expensive study. Furthermore, in undertaking it, the entrepreneur may have to enter into certain obligations (as 'confidentiality' obligations, or the payment of 'look-see' or 'disclosure fees', to the owner of vital technological information).

The usual practice is to carry out a 'prefeasibility' study which would provide order-of-magnitude data and

analysis. Unless knowledgeable consultants are employed, the prefeasibility study is usually based on information obtainable from general technical literature, profit-and-loss and balance sheet statements of companies (local or foreign) and, sometimes from project profiles prepared by government promotion agencies for public use. Where consultants are employed, they would normally be engineering companies familiar with the industry.

Very basically, the pre-feasibility study furnishes information as to how a product is put together (assembled), processed or manufactured from raw materials or 'starting materials'; the dependence of the production facility on outside-the-fence purchases (including imports); key manufacturing machinery and equipment; order-of-magnitude estimates of investment and production costs; approximate profitability; alternative manufacturing sites, and such closely related information.

While almost every element of this study will be upgraded in a detailed study following selection of the joint-venture partner, the pre-feasibility study is a useful document with which to approach venture partners. It indicates the seriousness of the entrepreneur, his ability to marshal data, and his preparedness to invest a certain level of funds in the venture, etc.

The pre-feasibility study also indicates many 'go' and 'no go' options to the entrepreneur himself: minimum needed market share; price 'floors'; profitability in relation to general market rates of return; etc.

The study can also permit an analysis of the consequences of making different kinds of decisions ('sensitivity studies').

Features of the Pre-feasibility Study

The prefeasibility study presents the following basic information:

- a. consumption data, by volume and value, for the manufacture of one unit of product (usually for a plant capacity regarded as 'economic'); it would cover raw materials, components, utilities (steam, power, fuel), labour; all of which permit an approximate calculation of the 'direct cost of production'
- b. key machinery and equipment that will need to be installed or employed (best guesses); estimated building and site areas; a plant layout diagram
- c. general processing/manufacturing/assembly sequences as applicable to the intended product, accompanied, if feasible, by flowcharts indicating, approximately, the quantitative flow of materials, and possibly

of energy consumed at various key stages (some broad assumptions will need to be made of the technology applied)

- d. estimates of fixed investment and working capital; foreign exchange requirements
- e. probable structure of investment - the debt/equity ratio (usually following norms of the industry or allowed by national governments)
- f. estimate of overhead costs (management costs); (this is usually a percentage figure applied on 'direct costs')
- g. costs of product marketing (if the entrepreneur proposes to directly market the product himself).. This cost - the selling cost - is usually a percentage applied on annual product sales value
- h. governmental subsidies and tax incentives
- i. forecast of sales- two or three scenarios
- j. pre-and post-tax profitabilities - usually for the two or three levels of sales assumed (and possibly for varying market prices)
- k. alternate avenues for reducing investment at the initial stage ('project phasing'), etc.

While to impress a potential venture partner a prefeasibility study should try and imitate the full-fledged project study as far as it is possible, its greatest drawback is that it assumes that a certain pattern of technology will be employed. Even if the study was to be made by competent consultants the drawback remains. This is because technologies of different firms reflect their different operating philosophies. They are not reducible to a single set of parameters (see following section).

Preliminary Definition of Project

Although a prefeasibility study has drawbacks, an entrepreneur seeking joint-venture participation must 'focus down' to a planned capacity. This capacity would have to be arguably consistent with levels of national imports, consumption in other countries (per-capita consumption), economic development plans of the host country, other producers in the national scene, etc. Likewise, projected profitability would have to be in line with general industry rates of return in the national economy, or if substantially higher, supportable.

Profitability estimates would be typically based at 80% of 'rated capacity', with the latter defined in terms of available market share 4-5 years after inception of the project.

At this stage, the entrepreneur would not normally identify the sharing of equity funds between the partners, leaving it for future negotiation.

Generally, in prefeasibility estimates, no provision will be made for technology fees since its form (royalty rate, an annual fixed royalty fee, 'lumpsum' payments or combinations thereof) and quantitative expression will be negotiated later. However, the prefeasibility study might evaluate the royalty norms established by national technology transfer registries, and where known, approved royalty rates for products resembling the intended product.

TECHNOLOGY ALTERNATIVES

In the context of the developing country, the national entrepreneur is more likely to select his foreign partner on the quality of the technology - product quality, production efficiencies, etc - that will be brought to the enterprise rather than on considerations of capital and management, even though the latter may be important determinants. This likelihood arises largely from the policies of developing country governments, which emphasise technology inputs. At the same time, with much of technology being in a 'sellers market', the entrepreneur may not have that choice open to him as would a buyer of products or, as a matter of that, even the leverage

of a firm seeking a straight-forward technology license. The national entrepreneur will probably only have the choice determined by the willingness of technology owners to financially participate in the country of the entrepreneur and, in particular, with him. Obviously, the choice exercisable by the national partner would be greater should he initiate the partner-seeking process rather than respond to international offers. This process of the entrepreneur initiating the joint-venture process has, therefore, many benefits and is to be recommended.

Even should the entrepreneur have a wide-enough selection slate - numerous potential partners - he is still liable to be bedevilled by the situation that he may not be able to select one with the most appropriate technology. This is because technology-owners traditionally resist disclosure of their technological knowhow till joint-venture arrangements near completion. Consequently, choice may become even narrower than what has been discussed above.

However, the technologies of all products are not hidden from the selector. In some areas the 'technology' is obvious. For instance, a firm intending to manufacture

typewriters can appreciate the technology (actually, the design philosophy) of various firms by examining their products or by disassembling them and studying constituent elements. In certain technologies, such as those of textile dyeing and the drawing of steel wire, it might be possible to visit manufacturers of machinery and to obtain from them sequences of 'dyeing' and 'drawing' operations since manufacturers of the candidate products will generally use 'off-the-shelf' purchased machinery and equipment.

In other cases, manufacturers of products themselves may be willing to show an entrepreneur their operations confident in the fact that no vital knowledge is transferred by visual inspection; for example, steel forging/casting operations, assembly of television sets, etc.

Access to such information is important to the entrepreneur. He obtains an appreciation of raw materials or components used, manufacturing sequences employed, the types of machinery utilised, the layout of manufacturing operations, the complexities of production organisation, etc. However, facets that would not be apparent from this inspection would be tolerances applied, speeds of processing, specifications of raw materials, quality control criteria, etc. These are elements of 'knowhow' (the confidential

segment of knowhow), the disclosure of which will not take place unless the technology-owner is compensated. Further, they are not always critical to technology selection.

The availability of even rudimentary information is extremely difficult in the 'process industries' viz. pesticides, drugs, alloys, resins, semi-conductors, etc. First, analysing a product such as a drug base or an alloy will not disclose what basic raw materials went into its manufacture. Second, a whole variety of alternate raw materials can be used for manufacture. Third, processes will vary with the cost and operating philosophies of their developers. For example, one firm may be oriented to reducing operating costs even should this have required a higher investment. Another may have developed a technology of continuous production, preferring it to a batch process, because of its higher uniformity of product values.

In light of this situation, the most viable strategy for the entrepreneur to obtain a wide enough selection slate in the process industries - applicable also to the other industries - is to seek, in the first place, a licensing offer unrelated to a joint-venture proposal; should this approach yield technical information from several technology-owners (as developing country experience shows it does) he will then seek financial collaboration with

the firms possessing appropriate technologies.

Operational Costs as a Parameter of Technological Strength

Whatever may be the situation, and however complex the product or production method, selection will ultimately reduce to a consideration of disclosed costs. That is, the strength of technologies is eventually reflected in costs. While there are several components of this cost - investment cost, direct operating cost, maintenance cost, overhead costs, etc - it is possible to conceptually divide them into two categories of costs: (1) production-related costs and (2) use-related costs. As long as the prime elements of such costs are disclosed much progress can be made towards technology selection. Correspondingly, in the absence of such costs there cannot be a rational evaluation of technologies.

In many cases, technological excellence is directly demonstrated by production-related costs. For instance, in 'commodity products' like cement or reinforcing steel bar, which are bought only on specifications (industry standards) that process which provides the lowest production cost (see Tables 1 & 2 - Total Operating Cost Method) will almost invariably be the most preferred. So long as data is available from technology-owners that

enables the construction of Table 1, a choice is possible. Where, in a situation, there are trademarks associated with commodity products, and the national market shows trademark preferences, a small 'premium' can be allowed. For example, if Product A has a production-related cost of \$100 per tonne and Product B, with a trade preference, at \$105 per tonne, the latter 'technology' may be the preferential one.

A different situation confronts the selector if there is, in addition, a use-related cost (or benefit). For example, if the selector is evaluating technologies associated with the production of heavy-duty trucks of Types A and B, and Truck B, through reduced consumption of diesel fuel (better technology), will provide a cost-saving to its user of \$10,000 over 5 years, the latter will be preferred other conditions being equivalent. In fact, technology B can have a higher price and yet be attractive.^{3/}

^{3/} If the market price of Truck A was \$15,000, and its useful life was 5 years, the user of the truck may expect to spend over its life \$80,000 on diesel. If the user instead used Truck B he may spend only \$70,000 on fuel (saved \$10,000). Thus, even if Truck B was priced at a premium of \$5,000 he would still save \$5,000 (i.e. half of the alternate cost). He would choose Truck B.

Correspondingly, the national entrepreneur, if he planned the production of 2000 trucks per annum, he would have the flexibility to pay the licensor of Technology B (for the technology) all of his gain, namely, \$5,000 x 2,000 = \$ 10 million, without disadvantage in purchasing the technology related to Truck B.

Similarly, if of two types of pumps, X and Y, Pump Y could be guaranteed to last for 5 years more than Pump X, or save its user \$5000 in 5 years in the use of electrical power, or both, its technology will be preferred even at a premium.

Use-related costs are 'product values' realised by the user. With practically no assistance from the supplier of technology, the potential acquirer of technology can assess these product values by contacting national distributors and users of products^{4/}

Therefore, the entrepreneur has to rely on the technology owner only for production-related costs.

In certain cases, where trademarks and patents of high importance are involved, production-related and use-related costs will not enable rational selection of technology. For example, the price at which a brand name perfume is marketed will generally be several fold higher than its production cost. Similarly, in the case of a patent-protected life-saving drug, there may be no choice in the matter of technology no matter how expensive the production process is. In these instances, the overall

^{4/} Use-related costs can, expectedly, vary from country to country depending on costs of fuel, energy, etc. The technology-owner, consequently, may not be the best source of such information.

profitability of the business can alone^{5/} be the guide to 'technology' selection.

In-depth Evaluation of Preferred Technologies

At some stage before the successful conclusion of a joint-venture agreement, the national partner will need to investigate, in greater detail, the technology he has selected. 'Definitions' and 'descriptions' of technology elements are technical issues to which the national partner will have to pay much attention. Discussion of such issues is presented in other Sections of this Monograph, and are highlighted in DTT/12. At this point, however, it might be useful to list the quality of information the national partner will generally be seeking in this effort.

Checklist of Technology-Related Parameters in Joint-Venture Agreements

(i) Product Quality:

Conformance of intended product to national
or international specifications

^{5/} The 'Ranking' and 'Points Systems' methods discussed later in this Section may still have relevance in these areas. Also see 'Guidelines for Evaluation of Transfer of Technology Agreements, DTT/12, page 62

(ii) 'Starting materials':

The national partner should ascertain what would be the 'starting materials' in the proposed joint venture; for example, steel stock, chemical raw materials, etc. or their forward-integrated inputs such as components, preprocessed materials, SKD or CKD^{6/} kits, etc (the extent of 'value addition' by the enterprise)

(iii) Basic process sequences and operations ('process description'):

Such information will highlight project complexity and define national inputs, environmental problems, skill requirements, etc. Importantly, it will identify the particular technology that the foreign partner will employ.

(iv) Major Machinery and equipment:

In joint ventures foreign partners may 'capitalise' machinery and equipment supplied by them. These will be enlisted in one or other of the joint-venture agreements. Such inputs will need to be appraised in terms of its value to the enterprise.

^{6/} CKD = 'completely knocked down'; SKD = 'semi-knocked down'.

(v) Capacity of Plant: Scale-up/scale-down flexibilities:

The plant in the developing country environment is often designed for a 'forward capacity' - for demand situations several years from plant inception. In the early years it must be flexible enough to operate at lower ('scaled down') capacities. On the other hand, if the plant is defined for present demand, it must incorporate 'scale-up' flexibility (achieved by 'pre-investment' in basic areas - land, buildings, utilities - so that larger capacity is achieved with minimum 'balancing equipment').

(vi) Product-mix and product-range:

In the developing country context, initial product-mix (say, types of bolts) may be restricted but the plant could be designed for a wider mix. Similarly with product-range (e.g. sizes of bolts).

(vii) Yields, productivity and efficiencies:

In technology agreements, licensors will usually indicate, and often guarantee, the performance of the plant at some level of capacity: yields (e.g. kilograms of product per kg of raw material); productivity (e.g. number of pieces per man-hour of operation); efficiencies (e.g. energy per unit of output); etc. These are prime indicators of the proficiency of the technology and are production-cost related.

METHODS OF APPRAISING TECHNOLOGICAL ALTERNATIVES

To the extent it becomes possible for the national entrepreneur to obtain economic data on alternative technologies, three methods, of varying sophistication, are available to him to carry out comparative evaluation. These methods are: (1) the Total Costing Method (2) the Ranking Method and (3) the Points System Method.

All the three methods are adaptable to procedures in developing countries where, for large projects, domestic companies often call for 'two-bid' offers from investors/technology owners. That is, the domestic companies require that offers be separated into 'commercial' and 'technical' offers. The enterprise first evaluates the offers in terms of technical excellence and suitability and the preferred technologies are then matched against commercial offers (investment proposals/costs). If a preferred technology is available in the context of an attractive investment proposition, or at the lowest cost, it becomes a strong candidate for final adoption.

While a nascent joint-venture company is unlikely to adopt this procedure - unless a government firm is a partner - the methodologies of evaluation presented here may be useful to it.

The first of these evaluatory methods - the Total Costing Method - is wholly conventional and it is universally employed for comparing technologies. There is very little subjectivity to it. However, as further discussion will show, it is not always appropriate to the developing country selection process because in it the 'qualities' of various costs are not the same.

The Ranking and Points System methods are more appropriate to developing countries even though subjective factors are employed in assessment. The Ranking Method, as its name implies, ranks technologies in terms of the evaluator's system of values (preferences). It yields results in the form of 'top rankers', 'middle rankers' and 'low rankers' without affecting a subclassification of technologies falling within a rank. It is best used for simple technologies and can be an important tool for screening a large number of technologies so as to get to a 'short list'. The method is also a rapid one, requiring a minimum amount of data.

The Point Systems Method is quite detailed and for its proper employment a substantial amount of information is required from the offerors of technology.

Neither of the latter two methods tests the profitability of employing a particular technology. Consequently the

Total Costing Method will have to be applied in addition for this purpose. In fact, in a complex technology system with several competing offers, the Ranking, Total Cost and Points System evaluations may be followed seriatim to the advantage of the national investor.

The methods are illustrated here using hypothetical data so that contrasts can be shown.

I. The Total Costing Method

Table 1 displays the primary data that five competing firms could have offered to the developing country entrepreneur in connection with a joint-venture proposal. (The hypothetical data is related to the manufacture of cooling water pumps in a plant rated to manufacture, at full capacity, 10,000 pumps per annum. It is assumed that pumps imported from all of the manufacturers are in use in the developing country and are available at a competitive price of \$ 1000 each).

In the Total Costing Method the national entrepreneur (licensee) will have to convert all of this data into 'dollar values'. So long as appropriate prices are used, and uniformly, no problems arise in evaluation.

Table 1

Input Data from Technology Suppliers

<u>Evaluator's Selection Parameter</u>	<u>Technology Supplier</u>				
	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
1. Estimated percentage of imported parts, % of sales price	10%	15%	15%	30%	20%
2. Energy required in the manufacturing process:					
(i) fuel gas, million BTU per pump	2.1	1.7	2.6	1.6	1.8
(ii) electric power, kwh per pump	300	350	350	280	370
3. Scrap rate, pumps per tonne raw material steel ^{1/}	8.4	6.9	7.5	9.0	9.2
4. Labour Requirement, annual man-hours	100,00	80,000	75,000	140,000	120,000
5. Total manufacturing investment ^{8/} million dollars	4.2	4.8	3.1	3.1	3.5
6. Technology Fee	\$900,000 Flat fee	\$150,000 +3% sales Royalty for 5 years	7.5% sales royalty last three of six years	\$600,000 Flat fee in 3 equal install- ments at the end of years 1,3 & 6	\$10,000 + 6% sales royalty for six years

^{1/} All steel purchased locally

^{8/} All manufacturing machinery procured locally

In Table 2 this conversion (using the cost base of a particular developing country^{9/} has been carried out and data evaluated. The method of calculating item 7 (technology fees) - which is a very important consideration in developing countries - is shown in Annex I (which also provides the rationale).

Technology A would, by this Total Costing Method, be the preferred technology as it displays the lowest production cost, the highest volume of profit and the best profitability (relative to investment).

If the 2-bid tendering process had been adopted, Technology A would continue to show technological strength^{10/} since operating cost - the sum of items (1) to (4) of Table 2 - is the lowest of the alternatives. However, it may not be the finally selected technology since its investment and technology cost components (depreciation and royalty) are higher than in the case of Technology D, and may exceed the enterprise's capability to raise funds.

^{9/} Costs are not shown but can be readily back-calculated.

^{10/} It is to be noted that without supply of any 'financial data' from the supplier of technology, the national entrepreneur, using known local costs, can arrive at the subtotal. These direct operating costs basically show the strength of the technology.

Table 2 .

Total Costing Method: Annual Costs of Production
(At Full Rated Capacity) and Profitability

Unit: Million Dollars
(Except item 10)

	<u>Technology</u>				
	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
1. Imported parts	1.00	1.50	1.50	3.00	2.00
2. Energy					
(i) Fuel gas	2.00	1.60	2.45	1.50	1.70
(ii) Electric power	0.60	0.70	0.70	0.56	0.74
3. Scrap Rate (cost of raw material steel)	2.95	3.95	3.65	3.00	2.95
4. Man power	<u>0.12</u>	<u>0.10</u>	<u>0.09</u>	<u>0.17</u>	<u>0.14</u>
Sub-total (1-4)	6.67	7.85	8.39	9.23	7.53
5. Overheads ^{11/}	0.40	0.40	0.40	0.40	0.40
6. Depreciation ^{12/}	0.42	0.48	0.31	0.31	0.35
7. Average annual royalty ^{13/}	<u>0.18</u>	<u>0.20</u>	<u>0.30</u>	<u>0.12</u>	<u>0.34</u>
Total annual production cost	7.67	8.93	9.40	9.06	8.62
8. Profit before tax, PBT	2.33	1.07	0.60	0.94	1.38
9. Profit after tax, (30% tax), PAT	1.63	0.75	0.42	0.66	0.97
10. PAT/Fixed investment ^{12/} Ratio	0.39	0.16	0.14	0.21	0.28

^{11/} Factory and sales overheads, including maintenance

^{12/} Fixed Investment equally distributed over 10 years (fixed investment includes interest cost during construction)

^{13/} Total royalty fee (see Annex I) divided by 5 years.

The disadvantage of this method is the indication that Technology A will be selected in all environments irrespective of factors as import restrictions, availabilities of energy forms, availability of foreign exchange, government regulation of royalty rates, etc.

The disadvantage, of course, arises from the fact that all selection parameters - items (1) to (6) in Table 1 - are given equal 'weight' in Table 2. The facts that Technology A consumes more energy (of a critical type) than Technology B, or that Technology E uses less of imported materials than Technology D, are not reflected in the evaluation, except through their market prices.

In the Ranking and Point Systems Methods such weightage is provided, more elaborately in the latter.

II. The Ranking Method

Table 3 shows how an entrepreneur in a particular developing country may view the 'weights' of the following four parameters of Table 1:

Table 3

Preference Weightage of Technology Parameters

<u>Parameter</u> ^{14/}	<u>Preference Weightage</u>
1. Imported products	0.30
2. Energy:	
Fuel gas	0.25
Electric power	0.20
3. Materials utilisation (steel usage)	0.15
4. Labour manpower	<u>0.10</u>
	1.00

What this table states is that, to the entrepreneur, conservation in the use of energy, followed by conservation in foreign exchange (continuing imports) are far more important than conservation in the use of manpower and steel. The entrepreneur also assigns his weightage preference.

In the Ranking Method, the first step is to rank each parameter of the technology with the highest number (rank) assigned to the technology that is most proficient in

^{14/}Investment outlay is not taken as a selection parameter in this example. It can be assumed that the evaluator has discarded it because all procurements are domestic.

that parameter (saves most foreign exchange, employs least energy etc). This ranking is illustrated in Table 4, using the data of Table 1.

Table 4

The Ranking of Technology Parameters

	<u>Technology Source</u>				
	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
1. Imported Products	4	3	3	1	2
2. Energy required:					
(i) Fuel gas	2	4	1	5	3
(ii) Electric power	3	2	2	4	1
3. Raw material utilisation (scrap rate)	4	1	2	3	4
4. Manpower	<u>3</u>	<u>4</u>	<u>5</u>	<u>1</u>	<u>2</u>
	16	14	13	14	12

(Highest number indicates best performance in the eyes of the evaluator)

Table 4 shows, for illustration, that Technology A is superior to all the other technologies in terms of conserving imports, while Technology C is superior in terms of requiring the least amount of manpower^{15/}

^{15/} It is to be noted that no 'dollar values' are given to the parameters so as to rank them (giving dollars values, of course, will not affect the ranking).

Since the conservation of imports and manpower usage do not have the same weightage, it is necessary to recast Table 4 giving the parameters the weightage assigned to them in Table 3. Table 5 illustrates the results.

Table 5

Weighted Results - the Ranking Method

<u>Selection Parameter</u>		<u>Technology</u>				
		<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
<u>Parameter</u>	<u>Weightage</u>					
1. Imported products	0.30	0.30	0.23	0.23	0.08	0.15
2. Energy required						
(i) fuel gas	0.25	0.10	0.20	0.05	0.25	0.15
(ii) electric power	0.20	0.15	0.10	0.10	0.25	0.05
3. Material utilisation	0.15	0.09	0.15	0.09	0.06	0.03
4. Manpower	0.10	<u>0.06</u>	<u>0.08</u>	<u>0.10</u>	<u>0.02</u>	<u>0.04</u>
		0.70	0.76	0.57	0.66	0.42
Weighted Rank		II	I	IV	III	V

The weight of any parameter in Table 5 is derived as follows:

$$\text{Weight} = \frac{\text{Rank of Parameter (i) in the particular technological process}}{\text{Highest rank number of that parameter(i) among the technologies}} \times (\text{weightage given to parameter(i)})$$

For example, the weightage for fuel gas usage for Technology B is obtained as follows:

$$\text{Weight} = \frac{4}{5} \times (0.25) = 0.20$$

where '4' is the rank position for the fuel gas parameter in Table 4; '5' is the highest rank received by any one technology in consideration of that parameter; and 0.25 is the weightage given to the fuel gas parameter in Table 3.

If the results of the Total Costing and Ranking Methods are compared (Tables 2 and 4) it will be found that for the concerned developing country entrepreneur, Technology B would be the more relevant even though it involves a higher cost of production, and is less profitable (profitability is low).

From Table 5, the following ranking emerges:

High rankers	-	A, B
Middle rankers	-	C, D
Low rankers	-	E

On this basis, the entrepreneur may only do an in-depth evaluation of technologies A-D, or only with A & B.

The Ranking Method, in order to be an easily workable technique, will typically use very few parameters. Little purpose would be served by making it more sophisticated. Its most important contribution is that it brings to bear on analysis the influence of key 'developing country' parameters. Once relevant technologies are identified by this analysis, they can be further tested by the 'Total Costing Method'.

The Ranking Method can also be applied to the data and results of Table 2 to select a technology with the 'best proportion' of investment, technology and operating costs (in the context of the developing country). These costs are, of course, beyond the evaluator's control.

The evaluator will, again, apply to the various costs a weightage scale. The assumed weightage scale in this example is:

Operating cost	-	45%
Technology fee	-	35%
Total Manufacturing investment	-	20%

The Ranking of the various technologies is as follows
(following the method illustrated in Table 4)

	<u>Technology</u>				
	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
Operating cost ^{16/}	2	1	4	3	5
Technology fee	4	3	2	5	1
Manufacturing investment	2	1	4	4	3

(Highest Rank = most favourable situation)

The weightage analysis, following the method of Table 5, works out as follows:

<u>Parameter</u>	Technology:	<u>Weighted Results</u>				
		<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
Operating cost		0.18	0.09	0.36	0.27	0.45
Technology fee		0.28	0.21	0.14	0.35	0.07
Manufacturing Investment		<u>0.10</u>	<u>0.05</u>	<u>0.20</u>	<u>0.20</u>	<u>0.15</u>
Weighted cost		0.56	0.35	0.70	0.82	0.67
Weighted Rank		IV	V	II	I	III

^{16/} Items 1-4 of Table 2.

The implication of this assessment - made only on well understood cost factors - is that Technology D would be preferred by the entrepreneur although it is not very profitable in its use.

The evaluator could, of course, have also given a weightage to 'profitability', considering four instead of three financial parameters. This may yield a different result^{17/}

III. The Points System Method

The Total Costing Method fails to account for many factors that should be evaluated in selecting technology; for example, pollution factors; worker safety; difficult operating conditions (use of high temperatures and pressures); etc. The Points System Method permits this as well as inputs as licensor experience, etc.

In this Method (see Table 6) the following steps are followed:

- (i) a full, but workable, list of all evaluation parameters is listed under various important classifications

^{17/} Use-related costs, discussed earlier, or other such parameters, can be readily accommodated in the Ranking Method.

(ii) the parameter the evaluator considers as the most important to his environment - the Reference Parameter - is given a 'weightage' of 100 (or some such round number)

(iii) the weightage of all the other parameter is assessed by the evaluator considering their importance relative to the Reference Parameter (they will, by definition, be less than 100). This gives the Points System Scale

(iv) one of the candidate technologies is taken as the Reference Technology

(v) for this Reference Technology, the evaluator will score points for the various parameters using the Points System scale, trying to give the highest score if the value of the parameter looks reasonable or a lower score if the value looks poor, unreasonable or is missing

(vi) with the Reference Technology thus scored, all the other technologies are compared to it and scored. Thus, some technologies may get a total score higher than that of the Reference Technology.

It will be apparent that a very substantial amount of information will be required to utilise the method and

that the evaluation can be cumbersome. Consequently, the method is used only for complex technology systems as that pertaining in petrochemicals, etc. In the Points System Method any and all types of parameters (cost-related and non-cost parameters) can be introduced so long as they are oriented to evaluating the impact of the technology.

In the example below (Table 6) four technologies for a hypothetical petrochemical are evaluated to illustrate the Points System Method. For purposes of brevity only 12 parameters are selected classified under 6 headings.

Table 6 shows Technology C to be superior^{18/} to all others and even better than the expectations of the Points System Scale. (Technologies B and D are not fully scored either because of absent information or the posture of their suppliers not to offer process guarantees).

Like the Ranking Method, the Points System Method does not indicate project profitability. However, in the normal

^{18/} The Points System Method should be used with caution. It is possible for a high score to be assigned to a relatively unimportant parameter (say, 'high pressure protection' in the example) and for it to compensate a serious deficit in a very critical area. Where there is such high scoring (above the assignment in the Points System Scale), it is better to test the technologies giving the parameter only the standard points assigned to it.

Table 6

Points System Method: Input Parameters and Evaluation

	<u>Points System Scale</u>	<u>Technology</u>			
		Reference Technology			
		<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>
A. Product Parameters:					
(i) Product purity	20	20	30	30	15
(ii) Product colour	50	40	10	45	40
		<u>60</u>	<u>40</u>	<u>75</u>	<u>55</u>
B. Raw Material & Supplies Parameters:					
(i) specification: raw material A (a)	40	30	10	35	30
(ii) specification: raw material B (a)	7	7	7	7	5
(iii) catalysts - diversity of supply sources	20	20	20	30	20
C. Consumption Parameters:					
(i) energy consumption	100	100	80	120	75
(ii) catalyst "	20	20	30	40	20
D. Process Guarantees:					
(i) energy consumption	80	80	0 (c)	80	80
(ii) effluent quality	30	20	0 (c)	50	0 (c)
E. Safety Parameters:					
(i) toxic chemicals (b)	25	20	10	20	0
(ii) high pressure protection	15	15	15	15	5
F. Technology cost (d)					
	<u>50</u>	<u>50</u>	<u>60</u>	<u>40</u>	<u>80</u>
	457	422	272	482	370

-
- Notes: (a) Entrepreneur prefers not to employ a technology which requires too rigid a specification of raw materials
- (b) Entrepreneur prefers, as far as feasible, a process that uses very few toxic chemicals (Technology D uses toxic chemicals).
- (c) Supplier of technology B has not provided any guarantees in his proposal.
- (d) A higher number of points indicates lower technology cost and vice versa.

situation, the evaluator would have already selected technologies for in-depth evaluation and in the process would have completed profitability studies.

SECTION II

SEEKING JOINT-VENTURE PARTNERSHIP

Why the Joint Venture: Linkages between Capital, Management and Technology

Since in the circumstances of the developing country an entrepreneur seeking an overseas joint-venture partner would fundamentally be seeking a source of technology, a clear understanding should prevail as to why the joint venture is a preferred instrument for the acquisition of technological skills. That is, the nexus between capital and technology should be recognised.

Three factors contribute to the association of capital with technology: (a) national government policies (b) 'tie-ins' by virtue of the investment philosophy of the technology-owner and (c) risk minimisation (or opportunity maximising) objectives of the national entrepreneur.

Developing country governments promote joint ventures with foreign participation in their desire to see that technology will be effectively utilised and that the manufacturing operation will be efficient. When a foreign venture partner brings capital with technology, he is expected to manage the 'package' in such a manner that it brings him the

best advantage. Such effort, it is believed, not only benefits the country but requires technology to be used in its most appropriate form.

However, the association of foreign capital with technology could arise from the policies of overseas firms. It may be, for example,

(1) the operational philosophy of the foreign firm that it is in the 'business' of marketing products, not technology; thus, that technology, in itself, "is not for sale"

(2) the view of the firm that returns on technology are too small in contrast to opportunities from direct investment

(3) the need to protect technology by close and immediate supervision over its use; feasible, in the eyes of the firm, through controls over investment; etc.

The national entrepreneur may himself prefer that the capital of the overseas firm be associated with the use of technology. Besides, the obvious input of foreign exchange:

(1) investment from the seller of technology implies his acceptance of market risks, and provides insurance that the technology employed would be relevant to the purposes

of the venture and appropriate to the market place

(2) 'capital' brings with it 'management' - a deficient and scarce resource in developing countries - and the opportunity this provides for acquiring management expertise

(3) the overseas investor becomes, from the viewpoint of protecting his investment, a reliable source of raw materials, components, etc - to the extent he has control over them

(4) the joint venture may lead to the acquiring of new markets by virtue of the influence the overseas partner may exercise in them (trading influence)

(5) the association provides assurances for the 'continuity' and the 'competitive viability' of the national enterprise by the access it has to the foreign investor's R&D - particularly 'process and product improvements' - and international 'market intelligence' and

(6) the joint venture presents a mechanism for later diversification into products and services which are supplementary or complementary lines of the overseas firm.

Against this background, it is evident that 'searching for a joint-venture partner' is basically an exercise of evaluating

technology alternatives supported by an analysis of 'what comes with it'. For the highlighting of issues involved in such evaluation and analysis, it is assumed, in the rest of this Section, that the association of foreign capital with technology is a choice of the national entrepreneur. In other words, it is assumed that technology would be available from its supplier without it being necessarily tied to investment.

'Searching for a joint-venture partner' implies the final possibility of succeeding - of convincing him to cooperate. The preparation that an entrepreneur must have to accomplish this is also a subject matter of this Section. It is probably the more important.

The term 'entrepreneur' needs definition. It should be noted that the potential foreign venture partner would be evaluating him as a credible partner throughout the period of negotiations.

The 'entrepreneur' is assumed to be one who can be accommodated within one of the following classifications: (1) a 'promoter' who will become a shareholder/director of the joint-venture company on its incorporation (2) an on-going national manufacturing company or (3) a national trading company wishing to engage in the production of such products which it has hitherto successfully traded.

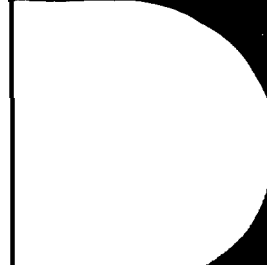
SMALL AND MEDIUM FIRMS AS PARTNERS

Market and political risks are, perhaps, the most significant factors which deter a foreign firm - particularly a small or medium-sized one - from independently seeking venture opportunities in developing countries. It consequently becomes necessary for entrepreneurs in developing countries to assume initiating and activist roles to establish joint ventures.

Small and medium foreign companies, as contrasted to transnational corporations, can be very attractive to emerging economies. First, they are unlikely to have the 'global interest' of the transnational which often entails that the developing country venture fit into some complex international pattern of production. Second, because of their limited ambit of operations, small-sized foreign firms would be less oriented to maximising 'global profit'; thus, more open to structuring the host country venture so that it gains as much of the opportunity directly open to it. Third, by not being involved in mass-marketed goods - cigarettes, soaps, soft drinks, etc - or in 'high technology' products - computers, telecommunications, etc - which require extensive distribution networks or massive fixed capital, small companies would have product ranges compatible with modest levels of investment and infrastructure.

Besides their suitability in the developing country context, small and medium overseas firms can also be attractive to the national entrepreneur. Following their own evolution, perhaps, such firms might be open to 'starting small' (if need be). Second, they might not have the capability to establish a production facility in the developing country all on their own; thus, they would prefer to share business risk with a partner who knows local conditions and the marketplace. Third, with 'top management' of the small overseas firm more accessible to the entrepreneur, he may be able to directly negotiate with key officials and shorten decision times. Fourthly, enterprises formed with small foreign companies are unlikely to have urgent obligations, via host country regulations, to spin-off equity capital through increased public ownership, etc.

Although all of these advantages come with the smaller firms, they may be accompanied by disadvantages. Among these are: (1) unlike the transnationals, they would have very little knowledge and experience of the economic/market structures of developing countries; consequently, they may not have corresponding management capabilities (2) because of their smaller size, they may not have the capacity to spare key and well-qualified personnel for extended periods of time - which personnel are often required in the developing country to train local people (3) they may not have the patience to



wait for governmental permits, undertake market surveys, engage in long-drawn out negotiations, etc.

It is unlikely that 'small' foreign firms would view capital involvement, per se, as a deterrent to establishing joint ventures in the developing country. They are more likely to see limits and obstacles in the market-place (tariff barriers, import quotas, national price controls, governmental regulations on the use of trademarks and patent rights), on the one hand, and of manoeuverability in production, viz. reliability of electric power, availability of skilled labour, etc. on the other.

THE TRANSNATIONAL CORPORATION AS PARTNER

There are several situations in which small and medium overseas firms may not be the most effective partners while transnational corporations would be. Such situations might arise from:

(i) the nature of the national market place: too limited in size or purchasing power requiring that export markets provide the 'base load' on the national facility

(ii). the enterprise's need to avail of large foreign exchange loans and credits

(iii) the marketing ambitions of national entrepreneurs - e.g. the manufacture and distribution of goods with international labels (such as soft drinks), or

(iv) the nature of the technology needed by the national enterprise: the technology may be a virtual monopoly of international majors e.g. automobile sub-systems; patented drugs; etc.

In such situations, the national enterprise may not stop at only seeking technology and capital but might require large infusions of management knowhow and market rights (product image, sensitised or controlled markets, wide patent monopoly, etc). The transnational corporation may be sought for its capability to provide the national enterprise with substantial management manpower and with routine assistance from its 'parent' company and international affiliates. Still further, the transnational may be sought so that through its reputation the enterprise may be able to obtain large loans and credits, reducing thereby risk capital needs (equity funds) of the enterprise.

The largest drawbacks to association with transnational corporations, however, are the socio-political attitudes of developing country governments to transnational investment, and the general insistence of the corporations on having clear controlling rights in the management of the national enterprise.

The governments have reason to be apprehensive of the transnational from the general tendency it has to extend its influence and power beyond the limits of the enterprise. Consequently, governments tend to impose many restrictions on the terms under which collaboration with transnationals can be accepted. The restrictions, while they lower the 'social cost' of transnational investments, have the effect of raising the cost of technology and associated services to the enterprise, depriving the national partner of a fair division of the 'inherent income'^{19/} of the enterprise. Thus, national policies have an indirect impact on the fortunes of the national partner.

The transnational corporation's insistence on management rights, however, has a direct impact on the influence of the national partner. The national partner may not be able to effectively influence the prices at which products are exported or the directions of export; to influence the costs at which the foreign partner hires and services the key personnel he appoints to the enterprise; to influence the enterprise to reach towards new markets that may be opening up; to diversify product-mix, product-range, etc. which ultimately could be of benefit to the enterprise, etc.

Nonetheless, the opportunities of working with a transnational may yet outweigh the aforestated impositions on the flexibility of the national partner. Except perhaps for

^{19/} See Section V.

mass marketed products, the national entrepreneur will usually have the choice of approaching either the transnational (for all their size, transnationals are known to work with small entrepreneurs) or the small firm.

SELLING THE PROJECT: CREATING THE JOINT VENTURE

An entrepreneur's access to technology, and its effective utilisation, often comes from the process that convinces the overseas owner of technology that he should invest in the entrepreneur's project. In its principal elements, what the entrepreneur would have to do to convince the overseas firm to collaborate are the following:

- (i) communicate that the entrepreneur would be a beneficial partner, bringing to bear on the joint venture certain unique and special advantages which ensure project viability and profitability
- (ii) illustrate that the national government provides certain incentives and inputs to attract foreign capital and that the government will safeguard the legitimate interests of the foreign venture partner in terms of capital and technology, and
- (iii) demonstrate that the country in which the investment will be made is, in itself, supportive of such investment through its structural

stability, economic growth rate, the emergence of markets, accessibility to resources and productive inputs, etc.

Facets concerning the viability of the national market-place and the market opportunity it presents have already been discussed in Section I. The dimensions of investment and factors concerned with profitability will be treated in Section V.

Item (ii) of the above listing - the national government's policies towards foreign investment and technology - would perhaps be crucial to the decision of the potential foreign partner to commit capital. The entrepreneur must consequently be well prepared to explain the features of such policies.

General Features of Foreign Investment Laws

Almost every developing country which actively seeks foreign investment or capital demonstrates its policies towards them through the promulgation of a 'foreign investment law' or 'code' (e.g. the Foreign Capital Inducement Law of South Korea; Investment Incentives Act of Malaysia; Law 43 concerning the Investment of Arab and Foreign Funds and the Free Zones of Egypt; the Foreign Exchange Regulation Act of India; the Joint-Venture Law of the Peoples Republic of China, etc). A statute rather than a code of administrative practice is generally the norm as it is then a self-

contained cohesive policy clear on the time frame.

A foreign investment law will generally comprise of several constituent sections. Typically, it would:

- (a) declare the general purposes of the law
- (b) define 'foreign capital', 'investment' and 'foreign company'
- (c) establish investment priorities by some system of classification
- (d) set out the schedule of incentives of privileges granted to foreign capital
- (e) formulate the terms and conditions under which foreign investment and capital will be accepted
- (f) specify the guarantees the Government will accord to foreign capital in terms of repatriation, nationalisation, expropriation, etc - in other words, the protection given to foreign capital - and
- (g) indicate the statutory authority that will have jurisdiction over the implementation of the law.

It is quite obvious that provisions under each element of this classification will be of utmost interest to the potential foreign partner.

Since foreign investment laws do vary very considerably in the depth and width of their provisions, it is only feasible to indicate here the essential homework the national entrepreneur must do before approaching a venture partner.

Checklist of Provisions in Foreign Investment Law

1. The definitions given to 'foreign company' and 'national (domestic) company': to define investment privileges, tax treatment, etc.
2. Definitions given in relation to 'foreign investment' inputs: 'Cash' and 'non-cash' inputs as equity; machinery and equipment as inputs of the foreign investor; supply of intangible assets as patents, trademarks, knowhow, services; pre-investment expenses of expatriate investor; re-invested capital of enterprise; etc. (These along with loans given by the foreign investor can often be capitalised and represent the foreign investor's contribution to equity - See Section V).
3. Sectors open to foreign investment:
Specified product/service sectors; investment in statutorily defined zones (free trade zones, remote areas, etc); investments in products intended for total or substantial export; investments in non-

conventional sources of energy; etc.

4. Investment priorities:

Classification of the intended project in terms of its priority rating - its ranking in terms of allowed foreign capital participation, tax incentives; etc.

(In the case of the Philippines, for example, industries are classified, consistent with its Investment Priorities Plan, Energy Priorities Program, etc. as 'pioneer' and 'non-pioneer' with pioneer activities obtaining better incentives. In pioneer industries, further, overseas investment is allowed to constitute 100% the equity of the national firm. In non-priority areas, a 40% equity limitation is imposed unless production is for exports, etc).

5. Privileges and incentives:

It is generally not feasible for market-economy developing countries to give incentives to foreign investment, such as tax benefits, which would not be applicable to companies with 100% national capital and management. (There are exceptions, however, e.g. Egypt). But with a view to attract foreign investment, incentives to industry in general may be substantial. Benefits would be in the form of 'tax holidays'; capitalisation of pre-incorporation costs; accelerated depreciation;

availability of low cost governments loans, subsidised power and land costs, etc. An important area of concern to foreign investors would be the privileges granted to them for the repatriation of dividends; profits; capital; depreciation; capital gains; the repayment of interests on foreign loans; reimbursement of 'headquarters expenses' etc.

In some countries there may be limitations on dividend remittances; imposition of 'excess profit' taxes; compulsion to maintain minimum reserves; minimum time period before capital can be repatriated; etc.

Certain countries may have concluded 'double taxation' treaties with traditional 'supplier countries' and the foreign investor may benefit from this. Tax and other privileges granted to expatriate employees is also of considerable concern to many foreign investors.

6. Terms and conditions for foreign capital participation:
In order for the foreign investor to enjoy the incentives and privileges granted to him under an appropriate foreign investment law, the domestic company which he helps form would be under certain constraints and obligations. Usually there is a requirement for the company to be registered with a prescribed authority defined in the investment law

(but also with other Governmental organisations e.g. Philippines); there may be a maximum limit to the share of foreign capital/voting stock (usually, for specific sectors, e.g. 34% in mining industry, Mexico) and/or the requirement of a minimum share holding by national investors (e.g. Republic of Korea; The People's Republic of China) or by the general public (e.g. Philippines, many Middle East countries); 'fade out' and 'spin off to minority' requirements may be present (India, Venezuela, Philippines), except perhaps for high priority areas, the law indicating the time period by which such fade-out/dilution should occur.

Foreign investment laws may also place obligations on the company in terms of its management. For example, the joint venture law of the People's Republic of China requires the Chairman of the company to be appointed by the Chinese partner. In India, the Government can appoint Government Directors to the Board if it is in the 'public interest'.

7. Guarantees of the national Government:

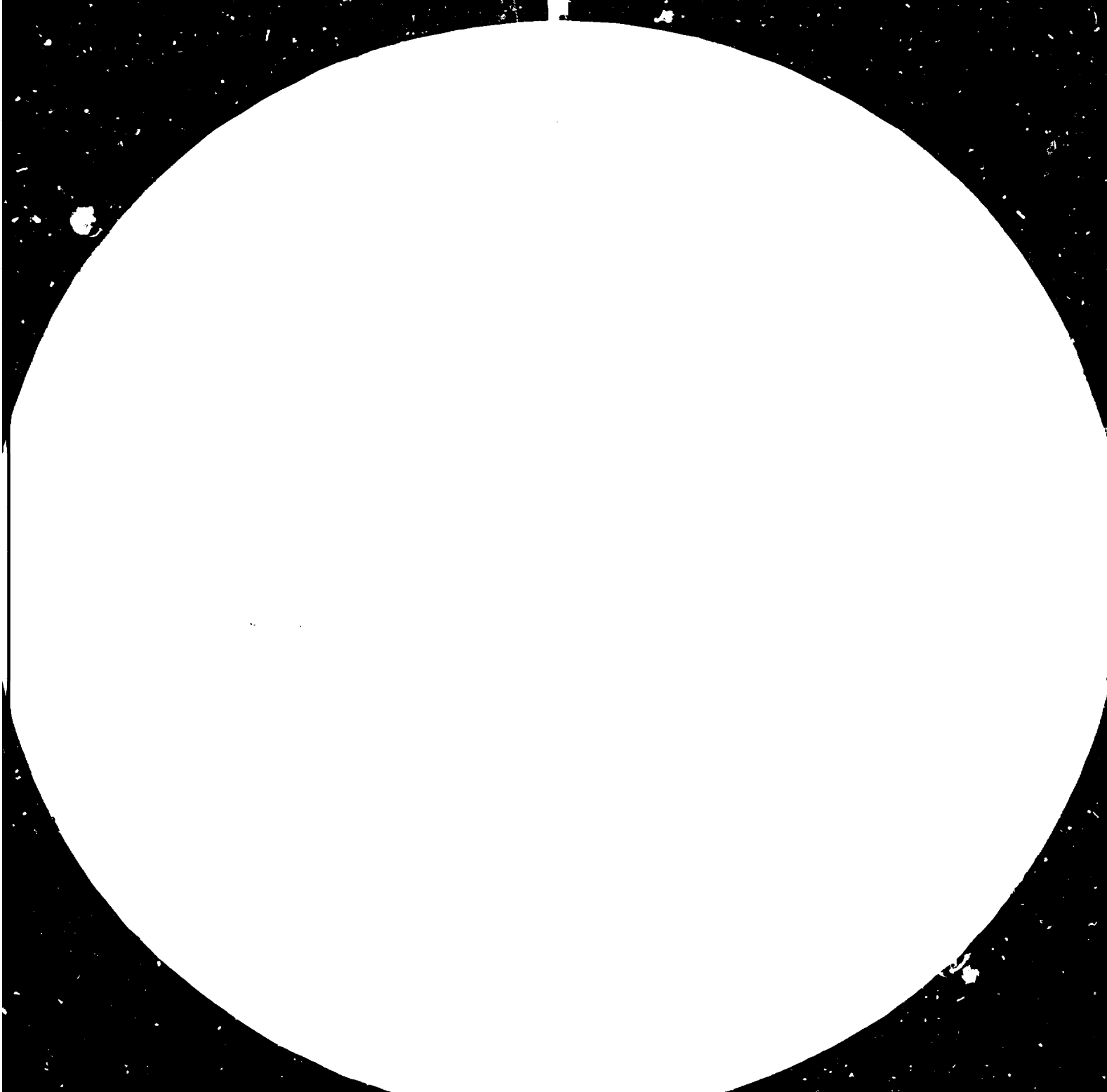
As the foreign investor will be concerned about the safeguard given by Government to his investment, the investment law will generally specify guarantees and immunities. In the case of some countries (e.g. India) the national constitution may set out some guarantees;

in others a law (e.g. Egypt's law 43) may provide them. Guarantees would relate to the nationalisation and confiscation of property; its seizure or sequestration; the right to repatriate capital and profits; revocation of foreign ownership rights; reduction in control of management; equality in the treatment of foreign and domestic investment, etc.

8. Identification of statutory authority that has jurisdiction over the implementation of the law:

In order to approve proposed investment levels; the degree of foreign ownership and management; to clarify tax privileges; to delineate exemptions and immunities; to administer those cases of foreign investment which are not specifically identified in the law; to register investments; etc investment laws will identify the statutory authority which has jurisdiction under the law (Foreign Investment Commission of PRC; sub-Secretariat of Foreign Investments in Argentine; General Authority for Investment and Free Zones in Egypt; the Foreign Investment Board in India, etc). Usually, registration with other Governmental organisations is required, importantly the central bank and the registration authority for company incorporation.

The above 'checklist' is obviously only indicative. It represents the minimum information that a potential foreign



partner will require to determine the feasibility of making the investment. Annex II provides excerpts of the provisions of some national investment laws to illustrate the variability of definition or provisions.

National Regulations Relating to Technology Transfer

While technology is a body of industrially useful knowledge, it is owned (proprietary) technology that is commercially important. National statutes generally protect the ownership and use of technology. These statutes cover patents, trademarks and (industrial) copyright - collectively called 'industrial property rights'. 'Knowhow' which is a composite of secret and non-secret industrial data, knowledge and techniques, is not covered by specific law. Its protection lies in 'case law' - judicial decisions arising from the resolution of conflicting issues. Courts have invariably decided on such issues by looking at trade secrets as 'property'. Knowhow is, thus, also an industrial property right.

The transfer of industrial property rights across national borders is protected not only by national legislation but also by international conventions (e.g. Paris Convention on Patents). Practically every major country is a signatory to the conventions. Knowhow, however, does not have a convention.

A 'transfer of technology' law, or code, which regulates the inflow and use of overseas technology would be the exception in market-economy industrialised countries. As long as a transaction is consistent with national legislation on industrial property, the exchange of rights and obligations in the use of acquired technology would be left to the parties to the transaction. (National legislation might, however, control the misuse of technology agreements to reduce competition etc - through the 'antitrust' and 'monopoly' laws which cover technology as a constituent activity of 'commerce').

The situation with the developing countries is generally very different. Those becoming increasingly reliant on the transfer of technology as a mechanism of national industrial development have generally evolved, in one form or another:

- (a) a legislative approach to regulate the import of technology with specific legislation enacted to cover the 'transfer of technology' (e.g. "Law for the Control and Registration of the Transfer and Exploitation of Patents and Trademarks" of Mexico; law relating to the "Registration of Contracts Providing for the Transfer of Technology and Related Agreements, Normative Act 015 of Brazil; law expressing the "Decision 24 of the Commission of the Cartagena Agreement of the Andean Group". (Other countries with a legislative system of

regulation are Argentina, Philippines, Portugal, Spain, Republic of Korea), and

- (b) a system of administrative handling based on general laws (e.g. the Industrial Development and Regulation Act, 1951 of India) and often supported by guidelines which are generally publicised (e.g. India, Malaysia); other countries following this mechanism are Egypt and Pakistan ^{20/}

In addition to the applicable law or related measures, the countries would also have enacted specific statutes on trademarks, patents and copyright. They would often also be signatories to international conventions (often a vital requirement for the transfer of technology across national boundaries).

A foreign owner of technology, intending to transfer it, will naturally be anxious over the protection he will get in the developing country and the terms and conditions he can legally impose over the use of technology.

^{20/}Two specific UNIDO documents that summarise technology transfer regulation systems (and their legal and/or administrative provisions) in developing countries are: "Review of Systems for Regulating Technology Inflows in Selected Developing Countries" UNIDO/IC.253 (5 Nov 1981) and "National Approaches to the Acquisition of Technology" Development and Transfer of Technology Series No.1 (1977).

The legal protection accorded to technology, the ways developing countries view legislation in the areas of patent and trademark protection, and practices being adopted by developing countries in regard to knowhow and technical services, can be found in several UNIDO publications ^{21/}. There would be little point in discussing them here.

However, the general view of developing countries on matters governing the acquisition of technology by national entrepreneurs is germane to this monograph. Giving consideration to it will help the national entrepreneur to prepare his "checklist".

As in the case of "foreign investment law", the "technology transfer law" of a government would be comprised of distinctive constituent elements:

- (1) objectives of the law
- (2) definitions given to "technology"
- (3) sectors where the use of foreign technology is permissible or impermissible
- (4) conditions to be met by acquirers of technology
- (5) terms and conditions imposable on the use of technology
- (6) compensation for technology
- (7) registration requirements; and
- (8) the administrative authority which will supervise the implementation of the law

21/

Guidelines for the Evaluation of Transfer of Technology Agreements, UNIDO, Development and Transfer of Technology, Series 12; TIES (Technological Information Exchange System) Newsletter published several times a year by UNIDO; See also DTT/14; ID/WG/197 1-5, Investment Promotion Meeting and Technological Consultations for Chemical Industries of Developing Countries, Bucharest, Romania, 2 - 6 Dec. 1973; DTT Series No. 14 "Case-Studies in the Acquisition of Technology (1)" and UNIDO/IS 253 "Review of Systems for Regulating Technology Inflows in Selected Developing Countries".

Checklist of Provisions under 'Technology Transfer Laws'

1. Definition of 'technology':

Technology may be defined widely (Mexico) or narrowly (Philippines). Almost invariably, the following elements of the technology 'portfolio' will be included in most laws and regulations: patents, trademarks, knowhow, technical assistance/services and basic/detailed engineering. However, elements as architectural design, copyright licenses, consultancy services, management and administrative services, personnel training services, computer programs, etc. - which may be parts of a technology transfer arrangement - may or may not find such expression or they might be clumped together with "other technological services". Understanding the definition given to technology will aid the national entrepreneur in determining its registration requirements and in drafting the technology licensing agreement.

2. Sectors where the use of technology would be permissible or impermissible:

Developing countries are vitally interested in the acquisition of technologies which can bring demonstrable gain to the economy - exports, labour employment, exploitation of natural resources, increased productivity through modernisation, etc. However, technologies for

products for which local technological capabilities exist (say, brickmaking) or technologies for products in 'overcrowded' sectors, etc may not be permitted (this usually implies that the Government will not sanction the payment of foreign exchange to the supplier of technology). The entrepreneur must thus determine whether his government will permit him to acquire (license) the technology of his interest, the patents and trademarks associated with it, and needed supportive services from the licensor.

3. Acquirers of technology:

Technology laws do not usually permit anyone and everyone to acquire technology or will give same rights to all acquirers. Thus, banks and non-resident aliens, to take extreme cases, may not be allowed to license (acquire) industrial technology; private sector corporations to acquire 'defence industry' technology, etc. (In PRC, for example, individuals, unless organised under a cooperative, are not allowed to acquire technology). Often, legislation favours that only joint-venture companies acquire foreign technology (Egypt, Malaysia).

4. Terms and conditions in the exploitation and use of technology:

(The term 'exploitation' is employed in legislation to denote the use of patent and trademark rights which can be, very substantially, monopoly rights in the hands of the transferor and transferee of technology). This constituent section of the law is perhaps the most important. The provisions here determine the flexibility given to the parties to frame the technology transfer contract.

Within the framework of this Monograph it is only possible to itemise those important provisions with which the national entrepreneur must be most conversant with and which will determine whether the foreign venture partner (licensor) will license out his technology.

Legislative provisions which the entrepreneur must closely consider are:

- (a) licensor's restrictions on the use of technology. Mexico's law, for example, prohibits the registration of technology contracts if there are certain compulsions on the licensee (for instance, permanent employment of personnel appointed by the licensor) or certain

specified restraints on him (viz. not to export acquirer's goods if in national interest; limits on level of production), etc.

- (b) the need to incorporate compulsory clauses in technology agreements. In India, Mexico and the Philippines, for example, the 'governing law of the contract' has to be national law; in India, sublicense grants are compulsory. In Mexico, agreements will not be registered if the supplier does not warrant the quality and results of the contracted technology, etc.
- (c) Maximum limits that must appear in agreements. In the Philippines, for example, the duration of a contract cannot exceed five years or contain an automatic renewal clause (but obligations on Philippine patents can prevail over the unexpired life of the patent). In India, only in exceptional cases, can the 'trade secrets' clause extend over five years. Similarly, there could be set limits to royalty rates (5% on net sales value in India and Philippines).
- (d) Reciprocal rights. The same rights should prevail for both transferor and transferee. This is usual for the 'grant back' clauses

of agreements pertaining to 'product and process improvements' but can apply to personnel training, etc.

(e) Allowable restrictions (if not contrary to national interest). In order to be pragmatic, and perhaps also to conform to international norms, most developing country governments will permit discretionary arrangements between the transacting parties. Governments, thus, may accept licensor's restraints on:

- export rights to countries where the licensor has operating licensees or owned production plants
- location of a production plant; its capacity; production range
- exclusivity of license (i.e. the grant of a non-exclusive license) etc.

5. Compensation for Technology

The code may state the allowable range of royalty rates for various industry sectors (e.g. India, Malaysia), set overall limits (e.g. Philippines) or leave them open for negotiation, subject to allowability by the registration authority (e.g. Spain, Mexico, Saudi Arabia). 'Lumpsum' payments, 'term

royalties', their combinations or variations, may or may not be allowed. Compensation norms for the use of trademarks, patents and knowhow may vary. For instance, royalties on trademarks are not permitted in India except in relation to exported goods.

Taxation on technology payments can vary greatly among the countries. Codes may specify who is responsible for the payment of taxes and whether royalty/fee remittances will be allowed on a pre/post-tax basis. Often laws (regulations under the laws) may require the licensor to furnish bank guarantees against lumpsum and similar payments. Payment of lumpsum fees in 'instalments' may be a regulatory requirement (e.g. India). Legislation may also compel that remittances be made only through the central bank (e.g. Malaysia).

6. 'Local Content' Requirements:

Governments of many developing countries (Philippines, Indonesia) require that technologies be so chosen that a certain minimum percentage of local materials and components are used. Developed countries, as the UK, also have local content requirements (but oriented to determining 'point of origin' of the manufactured product).

7. Registration Authority:

While the registration authority for technology agreements may be the same as that prevails over foreign investment (e.g. India) they are usually different (for example, in Nigeria the National Office of Industrial Property is solely concerned with technology licenses; in the Philippines, investment approvals are with the Board of Investment in the Ministry of Industry but technology agreements are with the inter-agency Technology Transfer Board).

Together with the registration of the agreement, other registration requirements are usually involved in the area of technology transfer - registration of patents and trademarks with the Patent and Trademark Registries, with Governmental Ministries, etc.

It is the international norm for the 'investment' and 'technology' agreements to be separate agreements. While one may refer to the other (and this is often desirable), it is theoretically possible for one to be fulfilled and the other 'frustrated', 'revoked' or 'annulled'.

LOCATING THE JOINT-VENTURE PARTNER

Unless a foreign firm approaches the national entrepreneur with the intention of floating a particular joint-venture activity, it will be the entrepreneur who, with slate of alternate investment opportunities, will seek overseas partners.

In the case of some products, locating potential partners and commencing discussions with them may be relatively straight forward, say, for a particular branded food product. However, in the more usual case the situation becomes difficult for the following reasons:

- (i) all known manufacturers of the product may not be willing to participate in joint ventures; reaching all would be too expensive while working with too few reduces options
- (ii) while a branded product may be doing well in the national market place, similar products with other brand names may do equally well but equivalents are not known to the entrepreneur (for example, pesticide formulations)
- (iii) the intended product is internationally marketed on specifications; any product with such specifications will be an acceptable product in the market place (e.g. sulphuric acid) but process-owners are not identifiable

- (iv) the candidate product is an unlabelled component of a machine or equipment and hence it is difficult to identify manufacturers of such products (e.g. valves on cooling water pumps)
- (v) the product of interest can be made with many alternative raw materials and the entrepreneur would like to use a nationally-located raw material (e.g. for chemical intermediates)
- (vi) the product, while using the same raw material, can be made through alternate processes (e.g. polystyrene crates) but owners of processes are not known
- (vii) the product is in wide international use but not in the national territory, etc.

While some two decades ago, the situation would have posed serious difficulties, many routes are available today to meet with technology-owners and to discuss joint-venture opportunities. Further, it is possible to minimise the costs of such exercise.

1. 'Technology-Data Banks': The most important vehicle for specific information are the 'technology data banks'

and associated technology transfer (licensing) services. These banks operate on an international scale.

UNIDO's INTIB (Industrial and Technological Information Bank) and its Technology Advisory Services Departments are fast developing sources. Information services may be available at nominal cost, but UNIDO will generally not participate in arranging collaboration.

There are, however, important commercial organisations wholly oriented to 'license broking' with voluminous data banks. Of these two might be mentioned in passing: Dr. Dvorkovitz and Associates and the Worldtech Division of Control Data Corporation^{22/}, both of the US. Such organisations, working through their international agents, seek to bring together the owners of technology and potential licensees, earning their fees through pre-arrangements with either the successful licensee or licensor. Their important contribution is that firms willing to license technologies and/or participate in venture capital are enlisted with them.

^{22/} Dr. Dvorkovitz and Associates, P.O. Box 1748, Ormond Beach, Florida 32074, USA; Control Data Worldtech Inc 7600 France Ave Co. Edina, Minnesota, 55435, USA.

Developed and developing country governments have also moved to establish data banks. Typical of the developed country sources would be the National Research Development Corporation (NRDC) Of UK and its equivalent, the ANVAR of France. Illustrative of developing country data banks are INFOTEC and CONACYT of Mexico and NRDC of India. These data banks mostly have a commercial character, are corporate entities, and will assume all the contractual obligations of a corporate licensor.

2. International 'Buyer-Seller' Meets

In recent years, buyer-seller meets have begun to take on the dimensions of a 'supermarket' for technology. These meets are organised as 'technology exhibitions'. Some commercial organisations hold several meets a year at different geographical locations (Dr. Dvorkovitz and Associates). In other cases, industry associations in particular countries (e.g. Holland) may syndicate to hold an annual exhibition. At these exhibitions, technology-owners are present and the potential licensee has the direct opportunity to discuss both licensing and joint venture with the technology-owners. In order to ensure that only seriously minded licensees are entertained, the admission fees to the meets are fairly steep. Because buyers and sellers meet on 'neutral grounds', and often in the context of competing buyers and sellers, the

psychological disadvantage of seeking a meeting on the licensor's own grounds is obviated.

3. International Professional Organisations

Since the late 1950s an international professional organisation, with multinational membership, has come into existence, and rapidly developed: the Licensing Executives Society, LES, (USA) which today, has numerous national chapters, including developing country chapters (e.g. Philippines). The membership of the association is wholly constituted of individuals who are engaged in the profession of licensing. Members of the organisation have access to a 'Technology Directory' which lists firms who are willing to license technology either 'in' or 'out'. Non-members can often gain valuable contacts by requesting the members of LES to assist them in arranging meetings with licensor corporations. The enquiring firm does not incur any obligation or expenses in seeking the assistance of LES members.

4. Investment Promotion Centres

Both developed and developing countries have set up agencies which promote joint ventures in developing countries. These agencies help to put potential partners together and provide them advisory services. Examples of such agencies, in the developed countries, are: Deutsche

Entwicklungsgesellschaft (DEG) of FRG, the Commonwealth Development Corporation (CDC) of the UK and Polservice of Poland, etc. Of the developing countries, the India Investment Centre, the Information Network of the Latin American Economic System (SELA) can be cited. In addition, UNIDO, in association with particular developed countries (e.g. Austria) has helped to develop institutional structures specifically oriented to providing liaison services to developing country entrepreneurs.

5. Journals

Gradually, a number of periodicals and newsletters are emerging which are oriented to publishing specific enquiries and offers of firms in developing and developed countries. Among these are:

- The UNIDO Newsletter
- 'International Licensing' of the UK
- 'World Tech Newsletter' of Control Data Corporation
- 'World Technology', Techni Research Associates, 41 Easton Road Willow Grove PA 19090 USA

PREPARATORY FRAMEWORK FOR
THE JOINT-VENTURE COMPANY

Although innovators would still pave the way, it would be rather unusual for a joint venture of any substantial size or structure in the developing country to emerge without a preparatory framework. In many cases, the joint venture will indeed blossom from some simpler association between the partners. In fact, a deliberately created simpler framework will not only lead to an enduring joint-venture relationship between the partners but can avoid the pitfalls and difficulties of establishing the initial joint venture. Essentially, the simpler framework establishes the required credibility for joint-venture association.

The simpler association can take on many forms:

(i) the national entrepreneur could become a distributor of the foreign firm's products and thus have a deep enough involvement in the market place, knowledgeable about the acceptance of the foreign firm's products, servicing capabilities and pricing policies. Likewise the overseas firm would be able to judge the competitiveness of his product in the national market place and possibilities of its growth.

(ii) the national entrepreneur may become, in a limited period contract, as subcontractor of the foreign firm assembling some product or other for export sales

(iii) in a closer relationship, the national firm could be a 'straight licensee' of the foreign partner in an unrelated field and thus have the capacity to demonstrate his managerial and market strengths, etc.

In other cases, the deliberate creation of a simpler association may help the parties in floating the intended joint venture. For example,

(i) the national entrepreneur may commence operations on a modest scale under a technology license agreement with the foreign firm. For instance, with the intention of later entering into a joint-venture relationship for, say, the manufacture of pesticide bases, the entrepreneur may be able to first enter into a formulation type of activity (simple processing operation) with modest investment and a low-cost license fee. In the associated license agreement, the option of the parties to enter into a later joint-venture agreement can perhaps be negotiated.

(ii) likewise, it may be possible to establish a 'mini' joint venture in the mechanical/electrical areas without significant financial involvement by the foreign partner. For instance, the 'mini' venture could involve the import of assembly-kits (SKD or CKD kits) imported from the foreign partner and assembly of the product in a small-scale enterprise. Although, such a venture could involve a '50-50' equity relationship - copartnership - most of the

funds of the enterprise could arise from a loan granted to the enterprise by the national partner. The partners will then be able to convert the mini-venture into a larger scale of operation by integrating backwards to basic raw materials. In such concept (the mini-venture), the foreign partner may not have the reservation - which is often a troublesome reservation - that he would be disclosing all of his technological knowhow without any guarantee he will receive enduring value from it.

Organisationally, too, a simpler association often helps. For example, the initial association between the partners could be a private limited (or 'closed') company with membership restricted only to two directors, one director appointed by each of the partners (see Section III). Such a company, with nominal capital, would be able to lease land, buildings, tools, etc. so as to quickly start assembly operations.

The private limited company can then become the 'promoter' of the larger joint-venture project, and when government approvals for the large venture are obtained, assimilate the leased property and increase its fixed assets base. Indeed, the private limited company could then convert itself into an open company (public limited company) so as to attract public equity capital, etc.

BACKGROUND OF THE FOREIGN PARTNER

Concurrent to the process of locating the foreign partner, it is necessary that the national entrepreneur investigate the background of potential partners. Good joint-venture agreements will often reflect or describe the backgrounds of the partners in the 'preamble' statements of the agreement (the "whereas" or 'recital' clauses^{23/}). The objective in highlighting background is to express the fact that the partners will be engaging in the joint venture 'with their eyes open'.

The following is a list of questions for which the national partner will have to find answers. In one or the other of the joint-venture agreements, the answers will find direct expression or will be strongly implied.

With "he" representing the foreign partner, the questions to be raised are:

1. Has he been in the particular business for a long period?
2. Is he a 'manufacturing' company?
3. Does he market the candidate products in his home market? In what name and under what trademarks?
4. How is the partner's company owned? Is there a holding company? Is the stock of the company quoted in the stock exchange?

^{23/} See DIT-12, p.51 'Guidelines for Evaluation of Transfer of Technology Agreements'

5. How widespread are his international operations?
In manufacture? In marketing? In after-sales services?
6. Does he have any type of operations in the region of the concerned developing country?
7. Does he have 'developing country experience'?
8. Does he own the technology that is proposed to be transferred? Will it be a direct transfer, through an affiliate, or some associated form of transfer?
9. What does his technology comprise of: knowhow, patents, trademarks, technical assistance?
10. Does he have the authority to license proprietary elements of the technology?
11. Can he take on 'turnkey' responsibilities to build the developing country plant? Has he done so previously? If he proposes to use third-party engineering and construction firms, has he worked with them before? Who are they? How are they owned?
12. Does he have the capability to provide managerial and technical training for the personnel of the developing country enterprise? Does he have an 'international division'?
13. Would he be able to spare, for reasonable periods of time, managerial and technical personnel to manage developing country enterprise?
14. In the manufacture of home country products (candidate products) what raw materials, components, auxiliaries does he purchase 'outside the fence'? Are these 'merchant' products, or are any of them under the control of the potential partner? Will the developing country enterprise have free access to them?

ORGANISED FORM OF THE VENTURE

Although Figure 1 indicates that the "form of the organisation" is decided after the foreign partner has been chosen, the entrepreneur must nevertheless have some idea

of what he feels would be a desirable structure before commencing negotiations with partners. He must enquire whether the organisation should be a proprietary concern, a partnership, a partnership company, a closed or open company, a company with limited or unlimited liability, one with public capital or not, etc. The entrepreneur must also consider what should be its form in the starting stage and at a point of its maturity. In fact, the foreign partner would expect to be guided in these matters as national situations differ greatly.

The form of the organisation will be basically decided on consideration of the following inter-related factors:

- (i) national legislation relating to company structures (for instance, whether the laws of incorporation allow the setting up of a partnership company)
- (ii) prevalent forms of national business (the normal patterns of business organisation in the country)
- (iii) the extensiveness of membership (that is, whether membership of shareholders should be widespread or restricted to an electable few)
- (iv) the liability exposure of the partners (whether liability should be limited by subscription, by guarantee, etc)
- (v) the needs of risk capital (whether the partners alone, and between them, can provide all of the required

risk funds or should the public be invited to subscribe to equity)

- (vi) the ease of raising capital in the capital markets (if the country had an active stock exchange, perhaps a form of company organisation that allows the investment of public capital may be warranted)
- (vii) national taxes on various forms of business organisation (for example, in a particular country taxes on a private limited company may be higher than for a public joint-stock company)
- (viii) required freedom from government control (a public limited company may be statutorily required to publish or register certain information which a private limited company may not be so obligated)
- (ix) administrative resources of the proposed company (a company may or may not have the administrative resources to comply with registration requirements required of a public limited company)
- (x) stock exchange listing requirements (if a company wanted to enlist its shares on the national stock exchange, stock exchange regulations may require that a prescribed minimum of shares be publicly owned, or that the non-voting stock of the company be lower than some fixed level, etc) and

(xi) socio-political framework (national policies may dictate that the capital of a company sooner or later be 'diffused' to the public, thus necessitating a form of company structure which would allow it to be enlisted on the national stock exchange).

SECTION III

THE INCORPORATION OF A COMPANY AND ITS INTERNAL REGULATIONS

AN OPERATING JOINT-VENTURE COMPANY IN PERSPECTIVE : A HIGH LIGHT OF ISSUES

Instead of proceeding to the next stage of this presentation - joint-venture negotiations - it might perhaps be useful, for the moment, to race ahead take a look at the joint-venture company^{24/} in operation. By raising a series of questions it may help to highlight issues discussed in this and other Sections of this monograph.

That the joint-venture company is in operation implies that it is being 'run' by somebody: by the Chairman of the Board of Directors, by the Managing Director, by a 'Chief Executive', or, possibly, by 'Joint Managing Directors'. How was such a person(s) chosen: could he be a 'representative' of the foreign partner? At what stage, in the concepting of the joint-venture, were decisions made as to who would 'run' it?

^{24/} To repeat, the joint-venture company referred to here can be assumed to be a company whose shareholders are two corporations. This assumption will enable the reader to assume that he is the national company. Generalisation to a multi-shareholder company will not alter the nature of the concepts discussed in this Section.

'Running a company' implies that it is being managed under some authority: that all matters are not in the hands of the chief executive officer or those of the board of the company; that there is a division of authority between the shareholders and the board. What documents would have delineated this division of authority? Again, could the partners to the joint venture have, with each of them, certain privileged non-contestable rights? What agreements, if any, would have enlisted these rights? Are the assumption and division of such rights and powers controlled, or modulated, by some superstructure?

In the operating company decisions may not always be taken with which the partners concur, or by some mechanism it may be possible for one partner's view to prevail despite the reservations, or downright opposition, of the other. What procedures, laws or arrangements make this possible?

In a company, decisions - big and small - are routinely taken. What provisions would have been made for the tabling of proposals and the taking of decisions on them: an exercise of stockholders' votes in a stockholder's meeting? A meeting of directors and an unanimous vote on the proposal ("directors present and voting")? Some other arrangement?

If any of the latter, who would actually be 'voting' on behalf of the foreign partner: the foreign venture partner's representative on the Board? in the Company? some person unrelated to the Company? Would such a person be permanently authorised to vote on all issues, and if so, how would this authority be expressed (given)? Indeed, would all decisions be arrived at by voting?

If the national partner is a 'minority shareholder' (incidentally, did he wish it?) would he be able to ordinarily block proposals which, in his view, are detrimental to the future of the company? On the other hand, if he was a majority shareholder, would he, by this mere position, be able to control the operations of the company to his particular advantage? In point of principle, are management and control singular rights of the majority partner or are they divisible? Where does the final authority for such matters lie?

If, in the Company under discussion, both partners 'see eye to eye' on all matters of the company can they then together take all decisions on its operations - or are there external limitations on the ambit of their powers.

For the routine working of the Company, annual 'capital' and 'Operating budgets' would be prime instruments of control. Would such budgets be formulated to the

satisfaction of the partners? In preparing the budgets would any policies - such as that of dividend distribution or 'ploughback' - be followed? What, if any, instruments express such policies? Again, the company must keep accounts; in what form and currency will it be maintained? How was this determined? When?

Coming to the area of problems that may not be entirely of the company's making, what arrangements might exist for their resolution? Should markets, or profits, for example, not build up to the expectations of the foreign partner, can he 'pull out' of the company at will? In negotiating the joint venture were such options discussed? If he does have the option to pull out, could he sell his stock in the company to anyone he wishes or would he be obliged to give 'first refusal' rights to the national venture partner? In such a case, how will the stock be appraised (valued)?

If on the other hand, the foreign venture partner (firm) was to lose his 'identity' by being brought over by, or merged with, another company (foreign company), would the national partner be compromised? Would provisions for such an eventuality have been made in some joint-venture document? Should both partners deem it wise, in certain circumstances, to 'wind up' the company, can they unilaterally do so?

What determined the capital structure of the company: majority voting rights desired by one of the shareholders or the unwillingness of one of the partners to put in more than a certain amount of money? Did cash contributions alone form the equity of the company or were there also non-cash inputs? If a technology agreement was executed by the partner (incidentally, were the partners 'signatories' to this agreement?) how does the flow of royalty fees to the foreign partner affect the distribution of the overall profit of the company? Did the national partner use any yardsticks to evaluate the relationship between equity holdings and royalty fees?

Would the sequence in which the technology-related and joint-venture agreements were executed have had any impact on the flexibility of the joint-venture enterprise? Has the capitalisation of certain non-cash assets adversely affected the national partner or the company? If so, how could it have been averted? Assuming the foreign partner had capitalised his 'technical services', could it have been advantageous to the company to have alternatively compensated the foreign partner through running royalties?

It is obvious in considering such issues, that venture partners must give a great deal of attention to the decision-making processes inherent in company operation.

Goodwill, for all its importance, is insufficient insurance that all will go well.

In the case of joint ventures established in developing countries the dimensions of all problems escalate. The largest and most important obstacles to the formulation of an equitable joint-venture arrangement are: (a) the inadequate experience of developing country entrepreneurs (and lawyers) in dealing with foreign firms, and thus, failure to negotiate the full rights otherwise available to a joint-venture partner in industrialised countries (b) the generally poor bargaining power of the developing country entrepreneur by virtue of his dependence on the foreign partner for technology, management and capital - and, often, markets (c) the distortion arising from much of modern technology being in a "seller's market" and (d) generally the absence, or the inadequacy, of national machinery to advise, monitor, supervise or regulate decision-processes in national companies.

THE INCORPORATION OF A COMPANY

Many - but not all - arrangements made between the joint-venture partners, and approaches to some of the questions posed in the preceding section, would generally be reflected in the documents that set down the 'constitution' of the company - the 'charter' or the 'memorandum' of

the company - and that of its internal operating guidelines: the 'byelaws' or 'articles of incorporation'. These are discussed in this Section. They provide the background for the important discussion in Section IV. (Negotiating Management and Control). Other issues will be discussed in the Sections on Joint-Venture Agreements, Capital Structure and Technology Agreements.

Instruments of Incorporation

The charters and bye-laws of companies have to be written such that they are consistent with national statutes of incorporation, among which there is commonly a 'company law'. In many countries, company law specifically provides model bye-laws, the inclusion of which in the documents of incorporation gives them full legal validity (e.g. UK, India). However, company laws usually give great latitude to companies in drafting bye-laws pertaining to issues of importance to the promoters. Bye-law provisions can, consequently, be quite complex. However, some of these bye-laws may hold the potential of being legally contested at a later date.

A company comes into existence, and can commence business in its name, only on its incorporation. The instrument of incorporation is usually a 'certificate of incorporation', 'registration certificate', etc. This is issued by a statutory body (named in company law) only when the proposed 'charter' and the 'bye-laws' are consistent with statutory requirements. A notary usually draws up

the documents and attests to the identity of its founders.

The charter of the company is generally a brief document. It would, typically, specify the name of the company, its registered address, the names of the founding members (signatories to the charter), its commercial objectives, the liability of the members, the 'authorised capital' of the company and its division into various types of stock (shares).

The bye-laws of a company will state how it will be regulated. From the point of view of this monograph, the most important aspect of the bye-laws is the enlistment of decision-making powers of the shareholders - the authority of the shareholders - and those of its directors and managers. This enlistment enables a distinction to be drawn between the 'management' and the 'control' of the company.

Below a 'checklist' is provided of the general content of the 'charter' and 'articles' as they would prevail in a developing country. Under practically every heading of this checklist it should be possible to introduce the regulations which would protect the individual interests of the partners (shareholders) and which the controlling law would recognise as discretionary and within the rights of the shareholders.

Because of their importance to the purposes of this monograph, separate attention is paid, in later sections, to discretionary provisions.

Checklist: The General Content of the Instruments of Incorporation

1. Name of Company:
name on incorporation

2. Structure/type of company:
proprietorship companies; partnerships; 'open' and 'closed' companies^{25/} etc.

3. Objectives of company
main and subsidiary objectives

4. Capitalisation:
Authorised ('registered') capital^{26/} subscribed

^{25/} Countries that follow the English system, define companies as 'public' and 'private' companies. In the USA, such companies are termed 'business' and 'private' corporations. In Spain, the equivalents are the 'SA' ('Sociedad Anonima') and 'SL' ('Sociedad de responsabilidad limitada') companies, etc. The general features of such companies are described later in this Section.

^{26/} Company law or other laws may require that the capital of a company should be some minimum figure for incorporation as a public joint-stock company, for entitlement to incentives etc.

capital^{27/}; currency of capital; types of shares to be issued (bearer shares, registered shares, etc); classification of shares (common, deferred, preference); denomination of shares; issue at par value or otherwise.

5. Voting rights of shares:

one-share-one-vote; multiple voting rights; non-voting shares; voting rights of preference stock.

6. Liability:

limited to subscribed value; limited by guarantee, etc.

7. Founder's names and qualifications:

Minimum number of founders; names; nationality/residence of founders; minimum shares founders must hold, etc.

8. Directors:

Where the company is managed by a board of directors.

- minimum number of directors
- government-appointed directors (where required by law)
- nationality/residence of directors
- minimum holding of shares
- term of directorship; retirement and rotation of directors; eligibility for renomination
- provisions for nomination of directors
- remuneration

^{27/}National laws may require authorised capital to be fully subscribed on incorporation; in other cases, a certain percentage of authorised capital may have to be 'paid in' (these are quite common requirements in the Latin American countries. In Brazil, for instance, 10% of subscribed capital must be deposited in a bank before the concerned authority will issue the certificate of incorporation). In El. Salvador, one-third of subscribed capital must be paid-in before commencement of business.

9. Management:

Delegation of responsibility to directors; management by 'committee of the board'; requirement for naming of 'Manager'; decisions by the passing of resolutions at board meetings, etc.

10. Control:

Decisions at 'general' and 'special' ('extraordinary') company meetings; definition of majority vote (simple majority; 'two-thirds' and 'three-quarters' majority votes); quorum (percentage of members and/or 'capital that must be present'); rights of minority shareholders to call a meeting of the company, etc.

11. Rights of Labour:

Representation on the Board (e.g. Spain); profit sharing (e.g. Peru); workers rights to appoint auditors to examine company accounts (e.g. Egypt).

12. Auditors:

Government-licensed auditors to inspect accounts, other arrangements.

13. Disclosure:

Reporting of financial data to government, to public, to share-holders; minimum disclosure formats (may be legal requirements); timing, etc.

14. Compulsory Reserves (legal reserves):

Legal provisions (many Latin American countries require that dividend payments be monitored so that a certain percentage of reserves is built up in the company)

15. Dividends:

If there is profit, minimum distribution may be a requirement (e.g. Brazil, Argentina).

16. Fade-out and Spin-off Provisions:

Due to national legal provisions (In Venezuela, for example, spin-off to 49% foreign control must be achieved in 15 years).

17. Liquidation/dissolution of company:

Procedures for liquidating a company; conformance to national legislation, etc.

The above listing is, at best, indicative. It makes no attempt at being comprehensive.

Documents of incorporation may be relatively simple and straight-forward in some countries (PRC, Egypt) but also could take on a complex structure in others (e.g. India). The above listing represents possibly the minimum knowledge that a developing country entrepreneur must acquire before he can negotiate parameters on the management and control of a joint-venture company.

In the following discussion an attempt is made to describe how a company is organised and controlled by looking at typical provisions of its charter and bye-laws. Because there can be very wide differences among countries as to how they permit the organisation of companies, this discussion can be considered, at best, a 'primer' on such matters. The discussion in Section IV relies on concepts presented in this primer, although some concepts in relation to management and control of a company are amplified in Section IV.

The charter and bye-laws of a company are generally required to be adopted by its shareholders at the first 'general' or 'stockholders' meeting of the company. They would have been drafted by the founders of the company and the company will have been incorporated prior to its first general meeting.

A company may be said to be regulated first by national laws, second by its charter and third by its bye-laws. Since bye-laws are subordinate to national laws, the rules that shareholders adopt to regulate the operations and decisions of the company may have their limitations. Frequently, the bye-laws repeat points from company law, whose focus is the regulation of companies in 'public interest' (India, UK, USA, etc).

The framing of the bye-laws differs with different types of corporate organisations. Of relevance to this monograph are these relating to industrial 'joint-stock' and 'partnership' companies.

Liability of Members

A joint-stock company can be a 'limited' company^{28/}

^{28/} The ways in which companies can be structured are specified in national statutes relating to company formation and regulation. In this monograph, company structures are defined in terms of those prevailing in developing countries following the English model. The concepts dealt with here will generally carryover to equivalent structures in other legal systems.

where the financial liability of each shareholder is limited to his subscription (the number of shares he subscribes to and their subscribed value), or an unlimited company (rare in industry). The shareholders of a company can also limit their liability to a 'guarantee' - the guarantee company - where each member undertakes that he will pay in a certain amount (the value determined by his guarantee) in the event the company goes into liquidation and realisation from the sales of its assets is deficient. In some countries (for example, Singapore) shareholders of a company can limit their liability to either subscription or guarantee.

A general feature of the public joint-stock company - expressed in its articles and safeguarded by company law - is that a shareholder can transfer any amount of his shares, at will, to any other shareholder or to any member of the public. The legal identity of the corporation is not altered in any way by this transfer. Also the person acquiring such stock automatically obtains the voting rights and other privileges of the transferor. However, there are variations. In 'closed' or 'private' limited companies shares may be transferable (under provisions of company law) only to existing members of the company.

The 'partnership company' is very similar, in organisation, to the joint-stock company - the liability of the founding

members is specific and shareholdings confer voting rights. The main difference lies in that the purchaser of a shareholder's shares (the transferee) does not obtain voting rights unless the transferee is specifically entitled to the voting privilege by the election of the transferee by the other members of the company. A majority of the members of the company, as well as a majority of the 'capital', may have to elect him. Except for this limitation, the shareholder is an equal participant with his peers relative to dividends, assets distribution on liquidation, etc.

There are two general types of 'limited' companies: the 'public limited' and 'private limited' companies^{29/}. For the private limited company, statutes of incorporation will generally prescribe that its membership remain below a certain number (e.g. 50 in India) and that the general public not be invited to subscribe to the capital of the company. The private limited company will generally not issue engraved shares (see later). It will also be less subject to public regulation than the public limited company.^{30/} The discussion in this and other Sections will generally be applicable to both types of companies.

^{29/} Also see foot-note on page 121.

^{30/} The public limited company, for example, may be required to hold a prescribed minimum of Directors Meetings a year (e.g. India), to publish or register balance sheets and/or profit-and-loss accounts, etc.

The Capital of a Company

The authorised capital is the maximum amount of share capital that a company can raise by virtue of provisions in the byelaws. Generally, but not in all countries, the authorised capital is raised in instalments of 'issued capital'. If subscription is lower than the issued capital, then the 'subscribed capital' - the total liability of the shareholders of the company - would be lower than what the company intended in issuing the capital. If shareholders pay in less than the subscribed capital (or if the company does not call, at the time, for all of the subscribed capital) then the 'paid-up capital' of a company would be lower than its subscribed capital. (However, the liability of individual members to their subscription is not thereby diminished).

A company raises its equity (share) capital by issuing shares (stock). There are various classes of shares with differing rights, benefits and 'voting' privileges. There are three principal classes of shares: equity shares (also called 'nominative', 'common' or 'ordinary' shares), preference shares, and deferred shares (also called 'founders' or 'promoters' shares).

Equity shares are the most important. Their holders bear the highest investment risk but also stand to make the highest profit. They generally contribute to the greatest part of the subscribed capital of a company. Equity

holders share in the profits of the company to the extent that the management of the company makes it available for distribution (dividends). Unless restricted under some law (e.g. a foreign investment law), dividends, to the extent the company thinks fit, will be declared in some proportion to earned profits and reserves ('undistributed' or 'retained' earnings).

Preference shares generally receive a fixed dividend (e.g. 9% preference shares) and have this right in priority to equity shares. They are risk-bearing shares since dividends accrue only if the company comes into the position of being able to pay dividends. While in only some countries it may be possible for a company to buy back its equity shares, in most countries it will be possible to 'redeem' preference shares by returning back preference capital (if such shares are issued as redeemable). On redemption, the original holders of preference shares will cease to be members of the company.

Deferred shares are usually issued only to founders, and where the raising of deferred capital is feasible (in terms of company law - viz. in Brazil, Israel, Mexico, etc), equity shares may be entitled to only a predetermined dividend rate. Founders' shares thus have residual

rights ^{31/}

The types of shares a company is entitled to issue is determined both by company law and by the specific byelaws of the company.

Shares usually have a 'nominal' or 'par' value. This value can vary with different classes of shares. Shares are 'engraved' numbered certificates issued by the company against cash and non-cash (machinery, land, patents) contributions from its shareholders.

Companies offer one of two principal kinds of equity shares: 'registered' shares and 'bearer' shares (sometimes called 'share warrants'). When registered shares change hands (are bought and sold), each new owner of shares is registered in the 'share register' of the company. Bearer shares (popular in the Latin American countries, Spain, Portugal, etc. and, to an extent, in Indonesia), on the other hand, are issued by the company to the shareholders who help form the company. They are given in exchange

^{31/} In Mexico, founder shares ('founder bonds') may be entitled to residual profits after allocation of a predetermined dividend to equity shareholders. In Brazil, on the other hand, it would be feasible to reserve up to 10% of net profits of the company for holders of deferred stock.

(conversion) for initially registered shares. (Thereafter, the first shareholder's name is deleted from the list of members of the company). A bearer share can be traded directly (transferred "by delivery" as with a 'negotiable instrument'), without reference to the company^{32/}. In some countries, (e.g. Spain) foreign firms can only acquire 'registered shares'. With bearer shares, change in the ownership of a company is hard to detect. It becomes known only when a holder of bearer shares is able to exercise his voting rights (bye-laws permitting) in a 'general' or 'special' meeting of a company.

A company can also issue 'stock' against fully paid shares. Stock can be divided into any amounts and sold in subdivisions without regard to the nominal value of the shares. Stocks are unnumbered. Owners of stocks are registered in the 'Stock Register' of the Company.

Voting Rights of Shares:

Different classes of shares have different 'voting rights'. They would be prescribed under the byelaws of the company. These rights are only exercisable in 'annual' and 'extraordinary' stockholder meetings (of the company). Equity shares, of the registered type, have full voting

^{32/} Dividends on the bearer shares are typically paid against coupons which are attached to the bearer shares.

rights, usually on a one-share-one-vote principle. Multiple voting rights, however, may be permitted under law, in certain countries (e.g. Nigeria, Thailand, Turkey). The shareholder of equity shares is generally a full 'member' of the company with rights to inspect certain of its documents and registers (specified in company law) and to attend stockholder meetings ^{33/}. The rights of a holder of bearer shares, on the other hand, may be curtailed: he may not be granted the right to attend annual meetings; to vote; to present a petition for winding up of the company; to inspect registers, etc. His basic right would be to participation in the profits of the company.

It might be noted that a company can also issue non-voting shares (e.g. Venezuela, Brazil) but company law may place a limitation on their percentage to total equity capital.

The holders of preference shares have limited rights and can vote only on those resolutions concerning them (usually on dividend declarations, its preferential distribution, new offers of preference shares, etc). Deferred shares, where offered, usually have disproportional voting rights - more than one vote per share.

^{33/} Under the law of some countries the privilege to attend company meetings, examine registers, etc. is limited to a minimum share holding.

The voting power of shareholders, of course, has immense bearing on the management and the control of a company.

Management of the Company

While the ultimate authority in the company rests with the shareholders, the normal running of a company is delegated by them (through provisions in the bye-laws) to its management - most often to a board of directors (with some special management powers granted to the Chief Executives Officer, Chairman or Managing Director). The bye-laws, however, will clearly specify those decisions which, to be effective, must be approved by the shareholders in a shareholders meeting.

The boards of industrial companies can be classified into three general types: (i) policy boards, sometimes called supervisory boards (ii) functional boards, sometimes referred to as internal boards and (iii) their combination, 'mixed boards'. The type of board the founders of a company may elect reflects the business ethos of a country and the needs of the enterprise. It is seldom legislated. The bye-laws of the company will generally be silent on the matter. In a policy board, the directors of the company will set policy and will not have executive (functional)

responsibilities in the day-to-day management of the company. In the functional board, the directors both set policy and have operating responsibilities. In the 'mixed board', some directors will be drawn from the company (executive directors) and others will be, generally, eminent public personalities or representatives of institutions associated with the enterprise ^{34/}.

Bye-laws usually specify both the 'minimum' and the 'maximum' number of directors that the Company can have (but an irreducible minimum may be specified in statutes of incorporation). Bye-laws will also specify that a director must be approved by the shareholders at a stockholders' meeting.

^{34/} The supervisory board is the general form in FRG for large corporations. In France, Companies may have both a supervisory board and a functional board.

Bye-laws generally do not define the number of internal and external directors. Company law usually requires that a minimum number of members - 'founding members' - be signatories to the documents of incorporation and the company may elect some or all of them as directors.

Except for those powers which the company has reserved for itself for exercise in stockholder meetings, all other decisions will be left to the board (will be the responsibility of the elected directors). However, the bye-laws may require that decisions on certain specific matters should be taken by the board only at a 'board meeting'; perhaps through the passing of resolutions submitted to the board; through majority vote or unanimous vote (possibly with the proviso that a quorum requirement was met), etc. Resolutions may relate to the issue of debentures, investment in other companies, the granting of loans, to the declaring of dividends, etc.

The control of a company

The powers reserved by the shareholders to themselves - such powers define the 'control' exercised by the shareholders over the 'powers' of the directors - can comprise of:

- (1) the increase in authorised capital of the company or its reduction; the capitalisation of reserves (the conversion of reserves into shares)

- (ii) the appointment of directors; the remuneration of directors, etc
- (iii) the passing of annual accounts
- (iv) the approval of dividends
- (v) changing or modifying the charter of the company or its articles
- (vi) appointment of auditors, etc.

'Ordinary' and 'special' Resolutions:

In the normal course of a company's business, shareholders exercise their controlling power by approving resolutions ('motions') placed before them (by the board) at stockholder meetings. Approval could be accorded by 'a show of hands', by the passing of 'ordinary' and 'special' resolutions, etc.

Bye-laws specify which matters require the passing of ordinary and special resolutions. An 'ordinary resolution' is generally one which can be passed by a show of hands (those 'opposed' and 'for' the resolution). For situations of conflict, bye-laws will generally provide for a 'poll' to be taken: the counting of votes. In a poll the ordinary resolution will be carried if shareholders owning a majority of the capital vote in its favour. Usually a poll is taken by counting the votes of members 'present and voting'. Bye-laws also provide for the 'proxy vote'. This enables an absent shareholder to have some authorised

person (the 'proxy') present at the meeting to vote on his behalf. (This person need not be a shareholder of the company).

A 'special resolution' (popular in the UK, in India, Hongkong, Spain, etc), where qualified in the bye-laws, would be one which requires for its adoption a 'two-thirds', 'three-quarters' or some such large majority.

Ordinary resolutions would be typically prescribed for the passing of accounts, the appointment (or re-appointment) of directors, the appointment of auditors, etc. Special resolutions, as perhaps can be anticipated, would be required for crucial matters - changing the objects of a company, modifying its articles, for permitting the board to raise loans above specified limits, the disposal of all or a substantial proportion of fixed assets, etc.

The special resolution can be a very important instrument in conflict situations and for situations which affect the structure of a company and its continuity. An illustration of the former kind would be the removal of a director during his term of office, and of the latter, the amalgamation of the company with another.

The calling of company meetings and the placing of resolutions before it are normally (under the bye-laws) 'notified'

events. Thus, shareholders holding strong opinions on the resolutions proposed by the board of their company would have time to consider their response and present themselves (or have their proxies present).

Ordinary and special resolutions have important implications to 'majority' and 'minority' shareholders as the following discussion will show.

Minority Control

It may be possible in a situation for a majority shareholder to so influence the framing of bye-laws as to require that certain key decisions - such as the election of the directors - be taken only by the passing of 'ordinary' resolutions. Thereby, such a shareholder can control the company even without having representation on the board. Except for remedies that may lie in Company Law or general laws, the minority shareholder might not be able to protect his legitimate interests.

On the other hand, a minority shareholder (or minority group) holding 35% or 25% of the share capital could have substantial influence on the company if the bye-laws required the passing of special resolutions on certain matters of vital interest to them.

This influence is, actually, of a negative character. It only permits the minority shareholder to 'block' a resolution. In such circumstances, the shareholder is said to have a 'blocking vote' or 'veto' powers.

A company which respects minority shareholder interests (national statutes are very conscious of this) but which at the same time requires expeditious handling of business matters, would normally incorporate into its bye-laws provisions for the adoption of both ordinary and special resolutions depending on the gravity of the matter they relate to ^{35/}.

It is important to recognise, in all of this discussion, that the passing of resolutions at a shareholders' meeting is, in point and principle, a means by which shareholders control the board of the company in whom they otherwise invest very wide powers. It should at the same time be recognised that the board has all rights

^{35/} In the Indian Companies Act, with its objectives to encourage minority foreign ownership, as well to protect minority shareholders in wholly national companies, specifies resolutions which have to be compulsorily 'Special resolutions'.

In Singapore it is not uncommon for a whole range of matters to be made subject to approval by special resolutions.

(and the duty)^{36/} to the management of the company except for the reserved powers.

The bye-laws also and usually envision the possibility that a company can 'wind up', either by 'voluntary liquidation' or enforced liquidation by its inability to pay its creditors or its taxes. While it is too complex a subject for discussion in this primer, it should be noted that the liquidation of a company has to be authorised by its shareholders. Resolutions to this effect (liquidation) may be 'ordinary' or 'special' resolutions. Once incorporated, a company in the eyes of law is a "permanent person" with infinite life. Its legal identity continues irrespective of changes in its ownership (the number and identity of its stockholders). It cannot cease to exist by the mere procedure of voluntary winding up. A court, on application, and with its consent has to order its 'dissolution'. Only then can a company cease to have its legal identity.

^{36/}Often a statutory duty.

SECTION IV

NEGOTIATING MANAGEMENT AND CONTROL
IN A JOINT-VENTURE COMPANY

General Review

Factors and facets:

- (i) in the 'management' of a company - basically how its day-to-day operations should be organised and directed, and
- (ii) in the 'control' of a company - what authority the owners of the enterprise will have over those who routinely manage it

will, expectedly, vary with the type and diversity of an enterprise's operations, the nature of the operating environment, the 'personalities' of the owners of the company, etc.

In the typical developing country joint venture many matters pertaining to management and control are basically 'negotiated' by the partners (although there are externalities which will influence their decisions). The promoters of the venture will tend to make arrangements among themselves

which will be oriented to their relative influence, rights and authority in matters of the structure, decisions and profits of the enterprise. Inherent to this negotiation process is the fact that the capacities and capabilities of those who create the enterprise will be unequal and different. Each may not be able to reap the same benefit from the enterprise or to hold equal sway over its decisions. This inequality calls for 'trade-offs' and compromise. It gives rise to the existence of contractual arrangements.

In negotiating the management and control of a company, its founders^{37/} will negotiate in three important areas:

(i) the most appropriate management structure for the company so that it can not only execute its routine intended operations but also protect their self-interests (ii) the rights and authority of the owners of the company over those of the management and (iii) the 'inter se' rights of the partners, that is, their relative rights in the two issues.

In the general case, the joint-venture company will be managed by a body of professionals - a multi-disciplinary team. The most responsible of this group would be the directors of the board. They would be elected (to the board)

^{37/} It is to be noted that in the model joint-venture company discussed in this monograph the founders are, in themselves, companies.

in the course of process in which the partners participate; that is, in a general meeting of the stockholders. The principal owners of the joint-venture company will rarely be its directors. (This is a particularly awkward concept when companies are the only stockholders). The owners, thus, would be acting through the directors in whom they will need to place great trust. The partners can be expected to nominate directors in whom they have great personal confidence and to try to secure their placement on the board.

The directors, of course, need a clear mandate so that they can manage the company without constant supervision by, or direction from, the owners. Consequently, the stockholders lay down (1) a set of guidelines which provides, and limits, the authority of the directors in various spheres of routine company operation and (2) a set of procedures for the taking of their decisions or for the making of proposals to the stockholders. Authority which is not accorded to the directors would then be reserved by the owners to themselves. This establishes the 'control' that the owners jointly have over the decisions of the board. The directors will not be able to act in these reserved areas without the consent of the stockholders. Consent would be accorded by the exercise of shareholder powers (voting privileges) in general stockholder meetings ^{38/}

^{38/} much of the terminology used in this Section is explained in Section III.

The earlier noted inequality between the founders arises from the facet that they contribute different qualities of assets (say, technology by one, and the 'national market' by the other), accept different orders of risk, and perceive priorities differently. Consequently, when consensus is reached on the establishment a company, it will represent a series of compromises on many essential issues. For example, in a company that will be co-owned 50:50 between the founding partners, the national partner may have given the foreign partner an important right in the management of the company - say, to nominate, on a no-contest basis the managing director of the company - in exchange for the consideration that the enterprise will employ a particular form of the foreign partner's technology. At the same time, for some similar consideration, the national partner may have negotiated that the sole agent who will be appointed to market the enterprise's products would be agreeable to both partners but that he will not be changed without the consent of the national partner. Such consent, of course, will only be given in a shareholders meeting.

It will be seen that whereas in a company with wide public holding it is possible to isolate management (the directors) from the owners of the company, the typical developing country joint venture usually involves a process in which

partner rights are expressly built into its pattern of management. Indeed partner rights in management are cross-traded against rights inherent in control. Thus, one often finds ventures in which the minority shareholder has obtained domination over the management; a majority investor without rights in control or management; and ventures in which, by legal-administrative arrangements, control and/or management power alternate between the partners.

The compromises of the partners on the matters of management and control will, basically, be set out in two documents: (1) the joint-venture agreement (see Section VII) and (ii) the bye-laws of the company.

In most developing countries, similar to the situation in industrialised countries, the joint-venture agreement will be 'personal' to the founders and not open to public scrutiny (even though the national government may require that it be approved by institutional bodies and registered). The bye-laws, on the other hand, will generally be open to the interested public since third parties who will do business with the enterprise must know the authority of, and the rights accorded to, the directors, etc. Very often, the bye-laws will provide evidence of the negotiated 'balance of power' between the founders.

It is outside the scope of this monograph to discuss in detail the merits of different forms of management, different company structures, different policy frameworks, etc. In the forthcoming material emphasis is only laid on those arrangements which enable the partners to establish their relative positions in the management and in the control of a company.

The Management of the Joint-Venture Company

The key issues to which the founders have to address themselves, in establishing the basic management structure of an enterprise, are the following:

- the vehicle for the management of the company (e.g. a 'board of directors'; solely through a chief executive officer; etc)
- 'supervisory', 'functional' or 'mixed' boards if a board form of management is adopted
- denominating the 'head' of the board: chairman/managing director/chief executive officer as applicable
- nomination/election of the 'head' of the board, and of the other directors

- representational role of directors ('proportional representation', for example;)
- functional roles of directors - finance; production; purchasing; etc
- term of appointment of directors; retirement of directors
- powers of the directors
- the decision-making process at the level of the board (unanimous decisions, majority votes, resolution 'by circulation', etc)
- procedures for the appointment of key functional officers of the company
- 'capital' and 'operating budget' procedures and budget reviews; budgetary approvals
- financial parameters: debt-equity ratio; dividend and cash flow policies; etc
- marketing arrangements; etc.

Essentially, they reduce to the three basic considerations:

- (i) the management structure of the company
- (ii) the powers of the directors; and
- (iii) the powers of the shareholders (owners).

Management Structure

Developing countries generally prefer that companies be managed by a 'board' rather than one or two principal officers on the reasoning that in the latter form of arrangement the managers of the company tend to become more responsive to those who have appointed them rather than to the needs of the enterprise. Further, it is felt that it also provides for adequate representation of nationals and also to put together a wider 'mix' of disciplines and experience.

The type of board that the enterprise should have - whether a supervisory ('policy') board, a functional one, or a mix of the two^{39/}- would partly depend on corporate practices in the environment and on the size and nature of a company's operations. In the early stages of a company's development, a functional board might be expedient if the directors were all to be drawn from the operating company. Where this is not feasible, a mixed board with some 'outside' directors may be adopted. In such boards, the partners will be able to nominate outside directors, some of whom may be directors on the boards of the founding companies.

^{39/} In some industrialised countries, e.g. France, companies may have both types of boards.

In deciding on the character of the board, the partners will be discussing the relative merits of a company being managed from a wide perspective (which a policy board provides) as against its disadvantage that distance removes the directors from specific responsibility (which, otherwise, is the key attribute of the functional board).

In situations where a policy board is adopted, it is often possible (that is, company law may allow) to have a 'committee of the board' to accept functional roles. Such a committee would normally have certain limits placed on it. However, the accountabilities of the directors would not be diminished by this delegation.

In the general case of the starting joint venture in the developing country, there would be merit in having a mixed board. In fact, the ability of the national partner to attract key civic personalities to the board could give him negotiating strength at the time of venture formation. To the foreign partner such participation can also represent a lowering of business risk.

In a fledgeling joint venture, with the partners concerned in finding their ways about each other, two important issues are likely to emerge: (i) to what extent is it possible to arrange that the directors will somehow represent

the characteristic self-directed interests of each of the partners, and (ii) in an unequal situation what specific arrangements can be made such that the interests of a partner in the minority position can be adequately protected. Thus, while issues in the management of a company are being discussed, each partner will be seeking a means - albeit indirect - of influencing the decisions of the board. Because arrangements in these areas may be crucial to the birth of a joint venture, the bye-laws of the company will reflect the relative considerations of the founding partners.

This situation is in contrast to the arrangements that prevail in large joint stock companies with substantial public shareholding. First, the management of the company will largely be independent of the owners even though the owners will nominate the directors for election. Second, the composition of the board will represent the ownership of the company. For example, in a company in which the lay public has an equal share of equity as the largest shareholder, each will have rights to the same number of directors.

The Directors of the Company and their authority

The number of directors to be appointed to the board, in practice, would depend on the size of a company and its

diversity of operations. The minimum number of directors would invariably be a statutory requirement. The maximum number will be a provision of the byelaws since otherwise one of the partners may be able to manipulate the decisions of the board by increasing the number of directors favourable to his interests. In practice, the number of directors will generally increase with time to reach the optimum required for intended operations (i.e. the maximum specified in the bye-laws).

The directors of the company will generally be nominated by the shareholders; but they will have to be elected to the board^{40/} by the decisions of the company in general meeting. Working directors (sometimes referred to as executive directors) would normally be professional persons chosen for their excellence and experience, while non-working directors would be persons of public eminence or persons drawn from the boards of the founder companies. Provisions for a right to nominate directors should be read in this context. Generally, the nomination and election of directors is carried

^{40/}The first board of the company will usually be the representatives of the partners who have negotiated the formation of the company. At the first meeting of the company (see Section III) these directors would offer themselves for election.

out without the implication that the partners are installing their representatives on the board.^{41/}

Directors as representatives of Promoters and Shareholders

There are situations, however, in which directors, in effect, become representatives of major shareholders or shareholder groups. In a three-way joint venture, say, involving a foreign partner, a national promoter and a bank^{42/} with the bank both lending funds to the company and participating in its equity, the bank may require that the decisions taken at the level of the board be protective of the purposes for which loans may have been taken (say, for acquiring machinery).

At the time of the inception of the joint venture it might have to be arranged that each of the three shareholders would have a non-contestable right to nominate a director

^{41/} In certain countries (e.g. Venezuela) such appointment may be legally required. Also, in certain legislations (e.g. India) it is possible for the corporation (including the founding corporation) to be a member. Thus, the representative board member can act or vote in the self-interest of his sponsor and advise him of the board's decisions.

^{42/} Other combinations are 'bank' substituted by a 'statutory government organisation', a 'third country partner', etc.

to the board and for decisions of the directors to be taken on a majority vote (q.v.), the weight of each director's vote being proportional to his nominator's share holdings. This is the system of 'proportional representation'. The bye-laws will have to incorporate provisions relating to this mechanism. At the same time, company law must permit such flexibility (as is the case in India).

In this context an option that can also be exercised by shareholders would be through the introduction of cumulative voting rights. In cumulative voting, the shareholders obtain, for every share they hold, as many votes as there are positions for directors (this system is widely adopted in the US). As a result of this cumulation, a minority partner's candidate can receive as many votes as does each of the several candidates of the major partner, who, desirous of electing a number of directors, is obliged to divide his votes among the number of candidates. ^{43/} Thus, under the cumulative voting principle, a minority

^{43/} The formula for ascertaining the minimum number of shares required to assure the election of a certain number of directors, is:

$$\frac{\text{Total number of shares outstanding} \times \text{Number of directors desired}}{\text{Total number of directors} + 1} + 1$$

(fraction following the integer is dropped)

If a shareholder wishes to elect 4 of a board of 5 directors in a company whose stock is divided into 1000 shares, he will require:

$$\frac{1000 \times 4}{5+1} + 1 = 667 \text{ shares}$$

It can be similarly calculated that if a shareholder controlled 167 shares he can secure (for his candidate) one position on the board (20% representation for 16.7% ownership) by massing his votes (5x167 = 835) for a single director. No matter how the remaining 833 shares (4165 votes) are divided among the five candidates, they cannot amount to as much as 835 votes.

partner can obtain a disproportionate (more favourable) representation in management.

The question of management influence in a '50/50' (or co-partnership) company poses certain 'special problems' since there would be no 'minority partner'. While, under the bye-laws a partner with 50%-plus-one-vote can control decisions taken at 'general meetings', rights of proportional representation at the level of the board can give no advantage. Each partner is likely to have rights to nominate the same number of directors as the other. Reciprocal rights (q.v.) sometimes alleviates this disadvantage.

The Chief Executive Officer (CEO): It is general practice to identify, from among the board of directors, a 'chief executive officer' (CEO). This officer may be called as such or as 'managing director', 'chairman', 'president', etc. In many developing countries, the practice is to have

a non-working director - an important business or civic personality - as the 'chairman' and a working director as its vice-chairman, managing director, etc. In developed countries, the chairman is viewed as interacting with the 'public constituencies' of the company and as providing the company with general direction. He may, or may not be, a working director. The managing director, president, etc is viewed as the CEO, directing the day-to-day operations of the company. Thus, there will be two very senior offices in the company, the incumbents of one looking out and the other (the CEO) looking in.

The CEO of the company would be responsible to the board and would have authority over other officers of the company although they may be elected by the board. He is often the chairman of the board of directors 'ex-officio' - that is, by virtue of this office - even though the bye-laws might give the board the right to fill this position with any of its members.

The CEO in the developing country is generally: (1) a named appointee of one of the partners by pre-arrangement (2) a person to be named by one of the partners or (3) one elected by the board from among its members. In all cases, the bye-laws of the company will normally require his confirmation by a decision of the company in general meeting.

In an embryonic joint venture, in the developing country, the venture partners would usually negotiate as to who will nominate the chief executive officer, and this right, by provisions in the joint-venture agreement, or in the company's by-laws, would be incontestable. Again, by private agreement (including the joint-venture agreement) or through by-laws, a partner may require that his nominee be a 'permanent' chief executive unless changed by him. Provisions relating to other directors, for instance, that they retire by rotation, etc. would not thus apply to the CEO. Likewise, the by-laws may provide - as a consequence of the arrangement between the partners on the management of the company - that the CEO cannot be removed from office by the company in general meeting. Foreign partners often make this a requirement when they are in a minority shareholding position with a significant investment outlay.

This set of tight provisions for establishing the CEO may represent the unusual case. If the foreign venture partner had a majority position he could easily reach this objective by requiring (in the by-laws) that nomination of the CEO be approved by a majority vote of the company in general meeting.

Reciprocal Rights: In certain situations, as in a 50:50 co-partnership company, it might be possible for the founders to administratively arrange for a nomination of the CEO in alternate periods. For instance, it may be negotiated that in alternate years the managing director, drawn from the board, would be one who is the nominee of one of the partners; and that the director who in that year steps out of that position would hold the position of 'deputy managing director'. (The positions of 'chairman' and 'managing director' are more often alternated as their duties and responsibilities are usually different). Provisions to this effect can be incorporated in either the joint-venture agreement - which lies outside of public review - or in the byelaws.

A problem arises sometimes from the consideration that in some legislations 'the managing director occupies a place of profit' - he is the manager who is accountable to the shareholders for profits. On this consideration, each partner may desire to have a 'managing director' on the board. The CEO positions may then be defined as: Joint Managing Director; Managing Director-Technical and Managing Director-Administration, etc. The figurehead of the board could be a working or non-working chairman.

The arrangement of reciprocal nomination rights can also be extended to other situations. Many times firms in a 'minority position' (arising from inadequate representation on the board despite ownership of majority stock or from holding less than 50% of the voting stock in a two-shareholder company) seek reciprocal rights to man key directoral positions. If the 'majority' partner negotiates the right to nominate the CEO, or a majority of the directors of the board, the 'minority partner' can obtain a great deal of counterbalance by having the right to nominate, say, the director in charge of sales, finance, etc. ^{44/}

Decision-making at the level of the board: The board of a company is entitled to take decisions - and in many legal systems is required to take decisions - on all matters which are not reserved for the company to take in shareholders meetings. The board, thus, has residual (but quite often, very wide) powers. The decisions or proposals^{45/} of a board are usually labelled 'resolutions'.

^{44/}It appears to be international convention for a shareholder holding more than 60% of the stock of a company to have the right to nominate the CEO and the Director-Finance. At a 50%+ holding, the specific right of nomination appears to be restricted to the CEO. Company laws, etc do not (usually) make any provisions in this regard in terms of percentage shareholdings. Foreign investment laws may, on the other hand, have controlling rights in these matters.

^{45/} Besides passing resolutions on issues within their decision authority, the directors also formulate proposals for eventual decision by the company in general meeting.

The decision authority of the board can be inferred from its bye-laws. The latter lay down specific matters over which the will of the shareholders prevail ^{46/}. These matters may relate to changing the objectives of the enterprise, changing capital structure or division of stock, the raising of loans beyond a specified level, the disposal of major assets, the appointment of auditors or sole selling agents, dissolution of the company, etc.

The extent to which the directors of the company are restrained from taking actionable decisions ^{47/} on the above matter emerges - very largely - from the collective arrangements that the founding companies make among themselves in floating the enterprise.

Besides providing for the exercise of their collective, pre-emptive, authority over the directors, the founding companies may also arrange that certain procedures be followed by the board in arriving at its decisions. These,

^{46/} The certain countries (e.g. India) company law may lay down those decisions which must only be taken by the company in a shareholders meeting.

^{47/} The board can take the decision, of course, that it would recommend to the shareholders (say) a raising of the equity capital of the company. This would eventually appear as a resolution ('special' or 'ordinary' as provided in the bye-laws) placed before the shareholders.

also, indirectly imply the 'balance of power' between the partners. For instance, the byelaws of the company may state that the decision on certain matters ^{48/} becomes effective only on the recorded 'unanimous vote' of all directors rather than on the normally provided majority vote (a quorum requirement being met). Thus a partner having the right, say, to only nominate one of six directors on a board, can feel confident that no issue of importance is likely ^{49/} to be decided without considering his interest. Likewise, to overcome problems of a 'tied vote', the chairman of the company may be given a second casting vote (national legislation permitting ^{50/} . Again, the requirement may be that the chairman of the company specifically chair directors' meetings.

In companies with substantial elements of public capital, or government capital, the directors will generally have greater flexibility in decision-making. Promoter companies,

^{48/} Decisions of the board, in its normal course of work, are not accessible to shareholders. The only formal way a shareholder (say, the foreign venture partner) can come to know of such decisions is through the access he may have to a director by the latter being his appointee on the board and under some legal obligation to him.

^{49/} This arises from the consideration that directors may not always act as expected of them by those who nominate them.

^{50/} For example, not feasible in Spain.

in these cases, may then require the articles to incorporate procedural provisions on the calling of director's meetings ("any director" calling the meeting), 'signatory requirements' ("all directors" signing the resolution that has been passed), etc so as to protect their interests.

AUTHORITY OF THE SHAREHOLDERS
(CONTROL IN THE COMPANY)

Since a company is established under the great risks assumed by its shareholders, there is no contest or challenge to their collective right to structure the company as they see fit, to the appointment of those who will manage it, or to their exercise of authority in key decisions of the company. National legislation, including the statutes of incorporation, expressly recognise these facets of control. Thus partners to a joint-venture company face little difficulty in focusing down to the elements of their collective control.

However, situations becomes complex when: because of a difference in their levels of shareholding, or contributions of assets of variable quality, one of the partners seeks a degree of control in the company which would be disproportionately superior to that of the other(s); two or more partners can act together to the disadvantage of the others; shareholders combine to act to the

disadvantage of a minority group of shareholders, etc. Illustrative of such situations are: (a) when a foreign partner contributing to, say, 30% of the equity capital of company requires the right to nominate a majority of the directors on its board and the CEO (b) when two partners A and B, owning 25% and 26%, respectively, of the capital of a company seek to control decisions in a company by requiring that voting on all issues be on the basis of simple majority and (c) when a majority of the shareholders seek to deprive a group of shareholders - say, owning 10% of the capital of the company - the right to claim that the directors of the company are mismanaging its affairs and to their detriment, etc.

Essentially, in any of the above situations, the basic issue is the legal protection that would be available to the minority partner on matters of vital interest to him.

The protection available to the minority partner may be present in national legislation. For example, it may be a provision in company law that decisions on sale of major assets must be reached by the company in general meeting and that the vote in its favour should exceed 75% of the voting capital of the company. That is, the company must pass a special resolution. Consequently, the majority partner (or partners) will not be able to cause

the disposal of major assets if the minority partner has a 'blocking vote' of 26% and does not exercise his vote in favour of the resolution proposing the disposal of majority assets. Likewise, it may be a provision of company law that any group of shareholders owning 10% of the stock of the company can call a general meeting of the company and in it appoint an auditor to examine and report on the books of the company. Consequently, the distributor of the company's products may have a 'safe investment' by contributing to 10% of its equity capital.

On the other hand, legislation may allow the shareholders to agree among themselves as to which matters should be ^{governed by} / special resolutions and which matters can be dealt with on the basis of a simple majority vote. In such a situation, a shareholder proposing to own 20% of the stock of a company may argue that the disposal of assets and the removal of a director should be the subjects of special resolutions and that the enabling resolution will be passed only when more than 80% of the votes cast are in its favour. Thus, unless the shareholder votes with his majority partner, the latter cannot unilaterally decide such issues.

Similarly, in a three-shareholder joint-venture, the partners may agree that the election of directors will be

on the basis of a simple majority vote (51% of its voting stock). In this venture, the shareholders may propose to hold 25%, 26% and 49% of the shares of the company. The arrangement has the consequence that no one shareholder can unilaterally cause the election of a director, and that at least two shareholders need to vote together ^{51/}to effect the appointment.

^{51/}It may be possible, at the same time, for two of the shareholders to enter into a legal agreement to vote together on the election of directors, with each of them having some right to nominate the directors. Alternatively, one shareholder may give his proxy to the other.

Another device, which may be permissible under laws of some countries, is the election of the directors of the company 'by a single resolution' (rather than the election of directors by the passing of separate resolutions relating to each of them). When, under the authority of the bye-laws, such a resolution is required to be passed as a 'special resolution', minority partners will be able to block it. Thus only that list of directors which is agreeable to all partners is likely to be put to vote.

In countries where legislation prohibits a foreign shareholder from holding more than 49% of the equity of a company, it is usually possible for him to arrange with a 'nominee shareholder' to hold 1%+ of such stock and for the two to vote together. In other cases, one of the partners, or a nominee, may be able to act as the trustee for a partner and thus act on his behalf. In some countries (e.g. Spain) the statutes may prohibit the creation of the trustee.

A foreign corporation may not wish to have a representative on the board for some reason. It may wish to protect its interests solely by virtue of the control it has through shareholdings. In his case, it must give the proxy to someone to vote on its behalf. The practice is then to give the proxy to someone not in the joint-venture company. None of the pre or post-incorporation agreements, or the bye-laws, needs to cover this point. However, the right to vote by proxy must be present in the bye-laws. (Even if the foreign corporation elected to have a 'permanent' director on the board, it may still be its preference to give its proxy to someone not in the joint-venture company. This would be the typical practice).

The relative authorities of the partners in the major decisions of a company is often a more important issue in joint-venture establishment than the factors and issues which determine the distribution of profit (the capitalisation of inputs - see Section V - the ratio of stock holdings, etc).

In the developed countries company legislation often provides ample scope for the partners to issue non-voting stock, multiple voting stock, etc so that the control of one of the partners can be established without the arrangement in any way affecting the division of profit^{52/} In the simplest instance such a requirement would seem rational if one of two partners in a company will be a mere 'sleeping partner' owning one half of its stock.

^{52/} In illustration, if A, B and C are three partners in a company, which will issue \$ 1000 stock equivalent to 100 shares, the division of profit among the partners can be arranged such that A receives half of it if he is contributing 50% of the venture capital of the company. A would receive 50 shares. However, if A and B were to hold 20% (\$200) of the stock which will be issued with multiple voting rights - say, with six votes per share - and A owns 15% of this amount, he will have a total voting power of 125 votes (35 votes from common stock and 90 votes from 15 shares with multiple voting rights) against a combined voting power of B and C of 75 votes (45 votes from common stock and 30 votes from 5 shares with multiple rights). Thus if the company to be formed is to have a board of ten directors, A will be in a position to have 6 of his nominees elected since he can sway more than 60% of the votes that will be cast. However, by owning only 50 or the 100 shares issued by the company, his entitlement to distributed profit remains at 50%.

In many developing countries, however, national legislation does not give latitude to companies to issue stock with multiple voting rights, non-voting stock, etc. This is often with the view to prevent a foreign partner transferring his controlling rights to a firm which may not have the approval of Government. But at the same time, such national authorities may generally permit a company structure in which, as earlier commented, management is in the hands of the partner whose equity stake is not high enough to warrant the right of control. Nonetheless, even with this prerogative, firms are known to overcapitalise their patents, technology, etc so that their equity position appears substantial enough to warrant control of the company.

The above discussion is wholly oriented to the negotiation process between the partners concerning matters of management and control. The negotiation is an essential activity in the establishment of all joint ventures. However, the process discussed does not, per se, involve the transfer of the expertise or the methodology of company management. It presumes that the entity receiving technology etc has the total capability, or will contribute to a substantial part of the capability, needed for managing the enterprise.

In the context of the developing country, of course, the joint venture is often viewed as an ancillary mechanism for the acquisition of managerial excellence. Consequently, directed efforts are made.

In the balance of this Section, the main methodologies of such acquisition are discussed.

THE MANAGEMENT AND THE MANAGEMENT SERVICES AGREEMENTS

Two very different types of agreements come under the common title of the 'management agreement'. The first of these, correctly the Management Agreement, concerns the operational management of an enterprise by an outside agency. The second is the Management Services Agreement wherein the foreign venture partner is contracted to provide certain manpower training services to the joint venture he helps float.

In the management agreement, which is quite prominent in the industrialised countries, the outside agency is usually an affiliate agency of one of the partners but it could also be a true 'third party'. The reasons for an enterprise

to engage a Manager Company (Consultant Company, etc) may be several: to obtain highly professional help; inability to accept a long-term liability for highly professional personnel; to enter into a sophisticated business; to solve a particularly difficult operational problem; etc.

In the management agreement the manager company will, under the supervision of the board of directors of the enterprise, establish the operating policies of the enterprise (marketing goals, financial norms, production lines, etc) and administer its operations (select suppliers, decide inventory levels, open new offices, appoint distributors, etc). The rights of the board of directors, or of the shareholders, would remain unaffected^{53/} and together they will hold ultimate authority in the enterprise.

The manager company will typically execute a fixed period agreement and will be compensated by a fixed annual fee, a turnover fee, etc. The manager company, by its definition, will execute its responsibilities by bringing in personnel to the managed enterprise. Such personnel, while they may be 'seconded' to the enterprise, will basically be accountable to the manager company and will perform their functions as directed by the board of the manager company.

^{53/} The Manager Company could, however, hold stock in the company and be represented on the board. Such positions strengthen the role of the manager company.

The Management Services Agreement, and the functions performed under it, on the other hand, are typically developing country oriented and would be optional to the enterprise. The services agreement requires that the foreign partner use his personnel to train nationals of the enterprise so that in a targeted framework of time they can fully, professionally and effectively manage the enterprise to achieve the goals the enterprise has set out for itself.

The services agreement will consequently incorporate a time-defined, 'fade-out' provision (which may also be a regulatory requirement in the developing country) under which the services donor company will cease to have an obligatory role in respect of management services and will withdraw expatriate personnel.

The services agreement is oriented to the development of national managers. The services donor company does not per se have any role in setting operational policies; neither would it have administrative responsibilities. Such are with the board of the enterprise. Since the services donor and the client joint-venture companies are distinct 'legal persons', the services agreement would often make it clear that all personnel of the enterprise, other than short-term personnel (q.v.) brought in by the services donor company, are under the supervision of the board of the services-recipient company i.e. the enterprise.

The services agreement is training oriented. The checklist that is provided below indicates the range of capabilities

that an enterprise may wish to develop. In examining this checklist, it will become apparent that, in some areas, like taxation, industrial relations, etc the services donor company may not be able to contribute much. In other areas - such as job analysis, job classifications, personnel appraisal, etc - that training will require exposing the personnel of the enterprise to on-going practices of the services donor (foreign partner) in parent company headquarters. In some cases, like the setting up of an internal audit department, the foreign partner may loan 'short-term personnel' from the parent company.

In a great many of the other areas, training will involve 'learning by doing'. In this nationals - 'understudies' - will be trained by working with the 'counterpart' staff of the foreign partner in the developing country location. What is often required by developing country governments^{54/} is that, over a predefined time frame, the foreign counterpart manager is 'phased out': he either leaves the enterprise or assumes a level of responsibility for which a trained national is still not available.

Because of the importance of such services, and the requirement that the foreign partner release key people

^{54/} Developing country governments often require that foreign partner's personnel be individually approved by the Government (e.g. India, Philippines) and their remuneration and length of service obtain specific sanctions.

from his own organisation, the basic understanding on the access to managerial services will need to be reached in the pre-incorporation agreements (see Section VII). Further, formally or informally, it is necessary that the partners establish the optimum organisational chart for the national company - optimum at some forward date. In such a chart, it should be possible to identify positions for which nationals will be groomed and the positions which will be initially manned by expatriates. The enterprise would ordinarily seek the right to approve the qualifications of expatriate personnel^{55/}

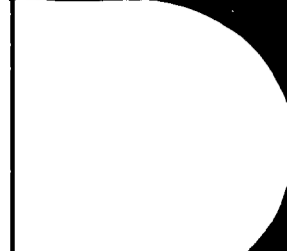
The management services agreement, like the technical services agreement^{56/} should be a comprehensive document sufficient in detail.

Compensation to the foreign partner, in the services agreement, may be a composite of two sets of fees: (1) that which represents the costs and overheads he bears in leasing his personnel to the enterprise^{57/} - usually a

^{55/} Typically, expatriates should be so selected to man several related positions.

^{56/} See DDT-12, p.5-7. Since management agreements do not require the foreign partner to accept highly specific liabilities (in contrast to the situation with knowhow, patent and trademark agreements), the detailing of services does not usually over-extend the foreign partner's legal obligations.

^{57/} As foreign personnel are phased out, these costs would reduce.



mark-up over direct salaries of such personnel and
(2) the management services fee - usually some proportion
of the enterprises turnover - or a fixed annual fee^{58/}

Representative checklist of features in management
services agreement

The foreign partner should provide to the enterprise,
advise, assistance, information and services in the following
areas as required by the enterprise:

- (a) general management, company organisation and corporate policies
- (b) planning and development of the company's business, including appraisal of investment opportunities
- (c) long and short-term forecasting and budgeting techniques and budgeting formats
- (d) preparation of in-house manuals for the reporting of sales, production, inventories, departmental costs, profits, etc
- (e) product-costing, product-pricing and product-distribution standards and policies
- (f) inventory standards and management
- (g) employment policies and practices; employee selection, training and placement
- (h) job analysis; job classification and rating; performance appraisals; promotion policies; job-rotation policies; salary administration

^{58/} In companies where the foreign partner holds controlling stock and manages the company it would be difficult to find a rationale for the second fee.

- (i) finance (capital and debt management) and accounting policies and standards; banking; insurance, taxation and property policies; the devising of information systems and methods of their management
- (j) internal audit policies and standards
- (k) purchasing policies and standards; purchasing techniques; purchase contracting
- (l) legal-secretarial functions
- (m) policies relating to public and government relations; industrial relations policies.

SECTION V

NEGOTIATING THE CAPITAL STRUCTURE OF
THE JOINT-VENTURE COMPANY

BACKGROUND

Governments and entrepreneurs in developing countries increasingly favour the joint venture as an instrument of national development and as an operating mode for exploiting marketing opportunities. Sought as a vehicle of technology transfer, it is preferred to straight licensing arrangements since it involves the technology-owner in investment risk. It is expected that the foreign venture partner, in attempting to minimise his risk exposure, will have to bring to the national enterprise efficient management, appropriate technology and products relevant in the national scene.

Foreign firms, in themselves, may also view the developing country joint venture as an attractive means of accomplishing their objectives, including that of lowering business risk. For example, the joint venture may provide them an opportunity to shift production sites from a high-cost environment to one of a perceived lower cost. Likewise, but more importantly, just as the national venture partner sees the joint venture as a vehicle of technology transfer, the foreign counterpart

may view the venture as a device to secure markets otherwise closed to him by tariff barriers, etc.

In this search for business alternatives, both the national promoter and the foreign firm are involved in the assessment of two types of risks. These we may identify as 'personal risks' and 'investment risks'. The latter are better defined and will be discussed later.

Relative to personal risks, the national venture partner is required to make an assessment of the technological, management and 'image' contributions of the intended foreign venture partner. Similarly, the foreign partner has to assess the capacity and capability of the national partner to organise labour, develop markets and influence business and governmental communities. These assessments, while they cannot be reduced to quantitative financial criteria, nonetheless affect the financial relationship between the partners. Each partner will have to give weightage to the perceived contributions of the other.

As is likely, each partner will assess his own contributions to his best advantage. This may not, however, be acceptable to the other. Such interplay of assessments will finally impact on the equity ratio of the joint-venture enterprise - for example, whether the national partner should contribute 60% or 70% of the risk capital (equity capital) of the company.

Because of the qualitative factors, there is no objective arithmetic that will determine a proper equity ratio for a particular type of joint-venture activity. Even if money was considered the only input of each of the partners to the overall equity of the enterprise, and inputs such as technology and national influence were disregarded, the equity ratio will still be determined by the maximum funds that one of the partners will invest in it. The criteria that determines this amount would, again, be qualitative.

The structuring of the equity capital of a joint-venture company is not always a determination of the partners. On qualitative grounds, governments of developing countries may set maxima (e.g. India) or minima (PRC). These will determine the maximum and minimum commitments a foreign venture partner can make to the enterprise (see later).

The equity ratio is not the first but the consequential determination of a series of investigations. Among

the most important are: (a) the capital needed by the enterprise to achieve its objectives (b) the ratio of loan-to-risk funds that can be achieved in a particular environment (c) the influence the partners seek to exercise over the employment of their funds and (d) as said before, possibly, the maximum risk funds - equity - that one of the partners will bring to the enterprise. Fundamentally it must be realised that a contribution to equity brings with it the clear right to vote on major business proposals of the enterprise and measures the strength of that right.

It is to be noted that once equity funds are committed, the shareholders legally surrender rights to its recovery. They are then only entitled to share in the surpluses (profits) of the company (enterprises), and should the company for some reason be dissolved, to share in residual assets on its winding up (dissolution).

THE CAPITAL STRUCTURE OF A COMPANY

Since equity funds represent the risk acceptance of the venture partners, the 'arithmetic' of investment decisions requires that financial commitment be: as low as possible but still consistent with: (a) expectations of profit - its absolute level and (b) enterprise profitability - after-tax return in relation to equity

funds. However, as the profit of a company is not generated on its equity capital but over the total funds employed by it, debt and equity must be evaluated jointly.

The Debt/Equity Ratio

Since it is in the nature of the corporate organisation to keep equity commitments to the lowest possible level (certainly in floating a new venture), debt, and thus the debt/equity ratio (D/E ratio), become important considerations. The optimum D/E ratio is 'negotiated' between the partners.

In deliberating the ratio, certain factors which affect it but which are outside the control of the partners, will have to be recognised:

(i) regulations in developing countries.

Countries which have regulations requiring that the Government approve joint-venture collaborations often require that the D/E ratio not exceed certain limits (e.g. 2:1 in India for industry). The reasons for such policy could be the need to maximise the use of risk capital in low priority industries; to reduce pressure on government lending agencies; etc.

(ii) attitudes of lending institutions. The organisations will be concerned with the ability of the enterprise to adequately 'service' loans: to maintain interest payment (a critical consideration) and loan repayment schedules out of its cash flow (depreciation, profits, investment allowances, etc).

(iii) policies of 'central banks'. Because developing countries are typically short of foreign exchange funds, the banks may limit use of foreign exchange loans.

(iv) requirements in the environment of the foreign partner. In certain countries, for instance in the US, the rating of a corporation in bond markets, and thus its stature as a responsible borrower of funds, is determined by the D/E ratio of the US corporations and its global affiliates/subsidiaries. Thus, such a corporation would not like to exceed a certain D/E ratio, etc.

Very significantly, the employed ratio may need to be geared to obtaining, presently or later, public equity subscription: a high ratio, by calling attention to interest liability, may not enthruse sharemarkets; on the other hand, too low a ratio may imply the company is 'overcapitalised' - incapable of paying an adequate level of dividends.

The composition of debt is also a negotiated element between the partners. It is usually determined by the 'costs' of various kinds of debts. For example, loans from developmental banks may be low cost (low interest rate and easy repayment terms) but their availability will be limited or tied to a low D/E ratio. On the other hand, loans from the public, in the form of debentures, may be more plentifully available but might require the payment of high interest rates and the offer of security (pledged fixed assets of the company). Each partner may prefer a particular composition.

Several quantitative techniques are available, importantly the Discounted Cash Flow Technique^{59/} to analyse the most suitable composition of debt and the appropriate D/E ratio. They are useful for optimising a business package once the partners have set limits in respect of their preferences, that is, to the composition of debt.

After the overall capital of the project and the D/E ratio are determined - say, for purposes of illustration, \$ 1,000,000 and 1.5/1, respectively - the needed equity fund of the enterprise is a consequent result (\$ 400,000 for the example). This must, of course, be provided

^{59/} See "Manual for the Preparation of Industrial Feasibility Studies" (UN ID/206 (1978)).

by the partners or some part must be raised from the public or a third partner.

Capitalisation of cash, Property and Services

In most joint ventures, the equity of a firm is a composite representing the 'cash' and 'non-cash' contributions of the partners helping to form it. The national partner may, for instance, be in a position to contribute land, buildings, offices, etc. Similarly, the foreign venture partner may be able to contribute - or take the position he will only contribute - the goodwill of his firm (trademark and name of the firm), patent rights, knowhow, designs and drawings, managerial services, etc. Likewise, the partners may be in a position to contribute different kinds of machinery (say, used machinery owned by the national partner and new machinery made by an overseas affiliate firm of the foreign partner). These would constitute 'non-cash' contributions.

Non-cash contributions usually arise from the fact that the contributions are 'surplus' to their contributors or give them some advantage. For instance, firms in many socialist countries of Eastern Europe can readily contribute machinery but not convertible currency.

Cash contributions are, of course, hard injections of money in its most liquid form. Entrepreneurs in

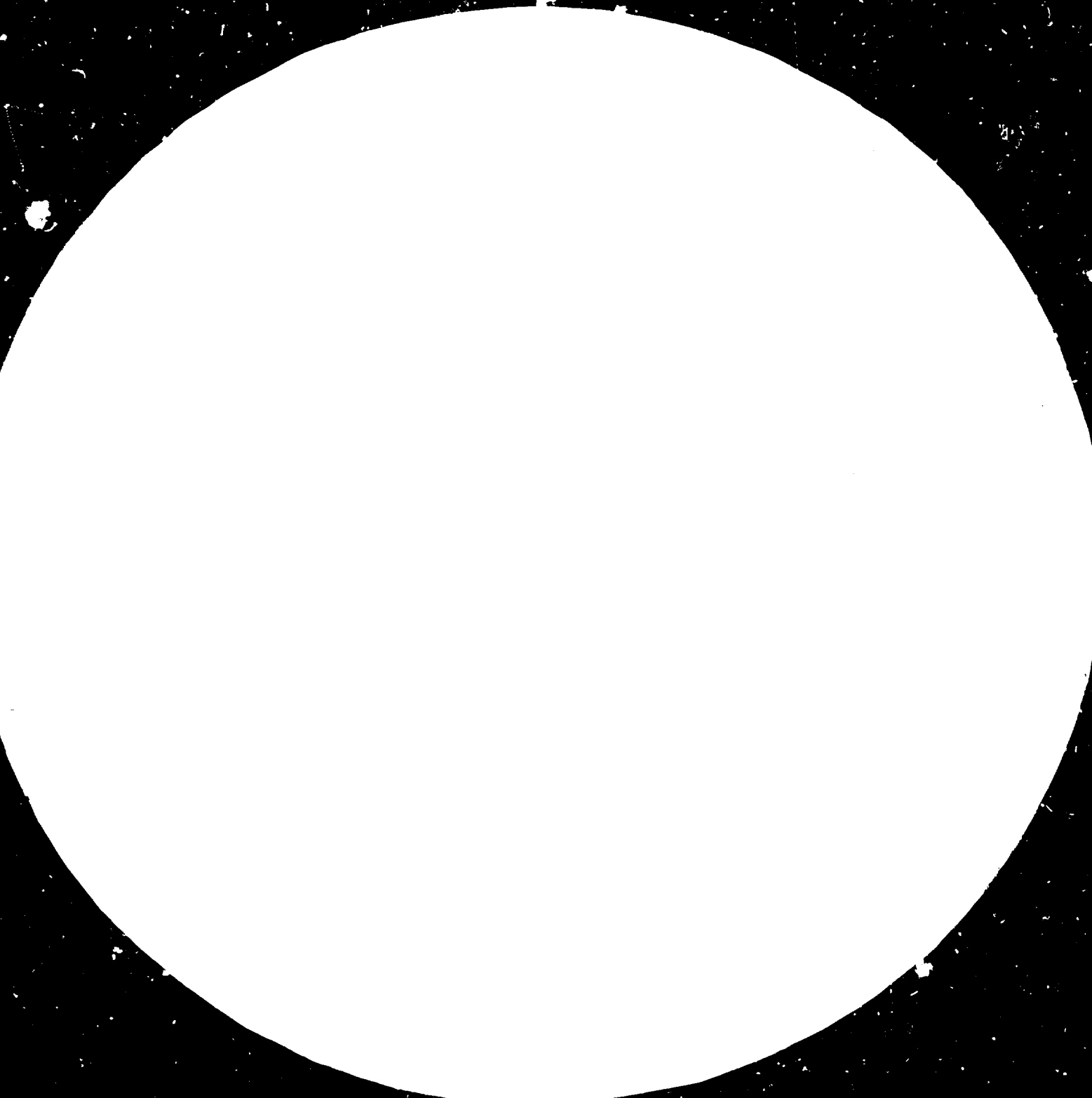
developing countries most often have to bear the highest burden in this respect.

The most vexing problem in determining a partner's contribution to equity is the estimation of the worth of his non-cash inputs: the 'capitalisation' of non-cash inputs. Each partner will have to assess and accept the worth claimed by the other in respect of his inputs.

Where there are tangible inputs, such as land, machinery, or moulds, a professional valuer may be able to do the evaluation^{60/}. With higher uncertainty, it may even be possible to assess the benefit in semi-tangible contributions as managerial and technical services supplied through foreign personnel: some percentage over the salaries prevailing in the country of the foreign partner

The greatest uncertainty, however, lies in the assessment of intangibles - knowhow, patent rights, etc. It is for this reason that many countries (e.g. India) limit the degree to which intangible assets can be capitalised.

^{60/}The administrative laws and/or the byelaws of many Latin American firms (joint ventures) require a shareholder-appointed committee of experts to do the evaluation.





2.8



3.2



3.6



MICROCOPY RESOLUTION TEST CHART

NATIONAL BUREAU OF STANDARDS-1963-A

It is to be noted that when intangible property is capitalised, the partner receiving the benefit obtains a permanent stream of income (profits) from the joint-venture enterprise (see below). However, it is often possible to limit the impact of this stream by licensing the technology instead of agreeing to its capitalisation^{61/}

Capitalisation of Intangible Property

If the foreign partner could establish a royalty rate which he otherwise obtains (from other licensees) for patents, technical services, knowhow, etc. an assessment of their capitalised value is possible under some general assumptions.

For example, if the royalty rate for a portfolio of grants (knowhow, patents, etc) was given by the foreign firm as 3% on net sales value, and the 5-year forecast of the firms' sales was as under:

Unit: '000 dollars

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Net Sales value (NSV)	1200	1400	1800	2500	4000

the capitalised value of the portfolio grant can be obtained by the technique of discounting future royalty

^{61/} Impact becomes limited by virtue of the fact that royalty payments are applicable only over a specified period.

incomes (see Annex I) to arrive at their 'net present value' (NPV) - the capitalisation. To illustrate the technique, the following assumptions are made: (1) the applicable discount rate in the developing country economy is 10%^{62/} and (2) the grant has significant value to the enterprise only for a period of five years^{63/}.

The capitalised value of the royalty rate (in the case of the above example) is the sum of the "npv's" under each year:

	Unit: 000 dollars, end-of-year payment				
	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Net sales value, NSV	1200	1400	1800	2500	4000
Royalty payable at 3% of sales (undiscounted)	36	42	54	75	120
Discounting a factor at 10% discount rate	1.1	1.21	1.33	1.46	1.61
'npv' of royalty, referred to year "0"	32.7	34.7	40.6	51.4	74.5
Capitalised value of 3% royalty rate on projected sales	-----233.90-----				

This capitalised value is the non-cash equity which the foreign firm can reasonably apply to the project.

^{62/} The discount rate is not the interest rate in an economy although it is related to it. It represents the weighted cost of obtaining funds from the money market. The applicable discount rate can be obtained from developmental banks and institutions.

^{63/} For illustration, it can be assumed that the licensed patents expire at the end of five years; or that the developing country government will not permit the use of licensed trademarks beyond five years.

In the absence of such data as the royalty rate, the local venture partner will have to carry out exercises to determine national or international rates for equivalent technology (equivalent products) and study their capitalised values; in the extreme, some assessment that capitalised services cannot exceed 10% (or some such number) of project fixed cost, will have to be made.

Although a generally applicable ratio does not exist, it is obvious that the three quantities represented by cash, semi-tangible and intangible assets must have some acceptable relationship. For instance, if the foreign partner's inputs were to be wholly intangible assets, he could be in the very privileged position of having control in a company without any exposure to risk. Also, the burden of raising much of the cash equity for the project will fall on the national partner.

Organisation of Capital

Assuming that the composition of equity capital of the proposed joint venture - the combination of land, machinery, knowhow, cash, etc - has been agreed to by the partners, they will have to establish as to how the stock of the company will be issued. This is not the straight-forward arithmetic of issuing shares to the

partners in proportion to their contributions. Stock, through its voting powers, establishes the degree of control which each partner will be able to exercise over the company.

It is possible to structure stock so that one of the partner's obtains outright or effective control of the company even though this partner does not hold a majority of its equity.

For example, if the distribution of common (or ordinary) stock in a two-partner enterprise is settled at 51/49, it is obvious that the ratio could not have been arrived at by the precise capitalisation of the partners' property contributions. It most probably arises from giving the 51% partner basic control of the company ('controlling stock').

Consequently, the control aspects of a company would need to be settled prior to determining how its stock will be structured.

Table 7 illustrates how the stock of a company can be organised so as to give Partner B control of the company even though Partner A provides most of the risk capital. The device that is adopted (here) is to give 'preference stock' to Partner A. It could alternatively be non-

Table 7

Structuring the Stock of Example A B Company

<u>Proposed contribution to assets of AB Company</u>	<u>Contributed by</u>	
	<u>Local partner (A)</u>	<u>Foreign partner (B)</u>
1. Land and buildings (\$)	230,000	-
2. Machinery (\$)	99,750	185,000
3. Knowhow and designs (\$)	-	147,500
4. Cash (\$)	167,500	50,000
	<u>467,250</u>	<u>382,500</u>

<u>Structure of Equity</u>	<u>Shares owned by</u>	
	<u>(A)</u>	<u>(B)</u>
1. Ordinary equity shares of \$10 each to be allotted to Partner A against cash payable by him	16,750	-
2. Ordinary equity shares of \$10 each to be allotted to Partner A in lieu of cash against agreement dated 1.1.1983 to sell land and buildings in LDC areas, valued at \$200,000, to AB company	20,000	-
3. 7% cumulative preference shares of \$10 each to be allotted to Partner A in lieu of cash against agreement dated 1.1.1983 to transfer machinery held by Partner A to AB Company, valued at \$99750	9,975	-
4. Ordinary equity shares of \$10 each to be allotted to Partner B in lieu of cash against agreements dated 1.1.1983 to supply machinery listed in Schedule X and to provide knowhow services and designs, total valued at \$ 332,500	-	33,250
5. Ordinary equity shares of \$10 each to be allotted to Partner B against cash payable by him.	-	5,000
	<u>46,725</u>	<u>38,250</u>

(Equity ratio between A and B is 46,725:38,250 = 55:45 but the foreign partner's control based on voting stock (ordinary shares) is $(33250+5000)/(33,250+5000 + 16750 + 20000) = 38,250/84975 = 0.51$).

voting common stock ^{64/}. By opting to own part of his equity as preference stock, Partner A sheds effective control of the company.

This type of structuring, done with the viewpoint of control, does not prevent the partners from contributing cash funds to the company in the form of loans to make up the whole, or part, of the overall capital of the company.

Income Share of the Foreign Venture Partner

For various reasons it may not be possible for the foreign partner to capitalise all of his intangible contributions. The foreign partner may not, for example, want to capitalise technology in the form of patents in order to maintain independent control of them. At other times, the uncertainties of tax laws may caution him. Still, again, governments of developing countries, as indicated earlier, may set limits on the extent to which intangible property can be capitalised.

In such situations, the foreign partner might 'lease' (license) his technology rights to the joint-venture company. Where this is followed, the foreign partner

^{64/} Preference stock is usually limited to a fixed dividend. It would enjoy voting rights only in terms of the company's policies as relates to preference stock. Non-voting common stock would receive the same dividends as on voting stock, but would not, of course, have voting rights.

obtains two streams of income: (1) profits by virtue of equity investment (say, through supply of machinery and cash) and (2) royalties by virtue of the lease of technology (say, knowhow) rights. The former will be of a 'permanent' nature (and it will, perhaps, increase in volume as the enterprise flourishes). Income as royalties, however, will generally have a short life.

Where this type of a situation holds, it is possible for most of the profit of the national enterprise, in the early years, to flow to the foreign partner, disproportionate to his equity holding. This possibility may be resisted by the governments of developing countries.

It is consequently necessary for the national partner to assess, in advance of entering into a joint-venture agreement, the impact of such flows.

A. Case of Direct Licensing In order to illustrate the principles involved in such assessment, it is first assumed that the enterprise is not a joint venture but has only licensed technology from the foreign firm. Thus, the obligation of the enterprise will be solely that of paying a royalty to the licensor. Second, it is assumed that the term of royalty payments is restricted to a short period of time (say, five years).

Table 8 shows, for an illustrative case, that once the royalty payment period of five years is over (royalty taken as 4% on sales), the profit-before-tax (PBT) of the enterprise 'increases' (by 4 units to 54). Actually, this is not a real increase. It is the share the foreign firm (licensor) hitherto had in the profits of the national enterprise through income as royalty. When royalty obligations lapsed (year 6), the 'inherent profit' of the enterprise showed up; that is, its long-term profitability.

Table 8

Income Share of Foreign Firm as 'Licensor' to an Enterprise

Basis: Currency Units

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6</u>
1. Net sales value units	100	100	100	100	100	100
2. Cost of production excluding royalty	46	46	46	46	46	46
3. Royalty payment (R), Royalty payable to Licensor	4	4	4	4	4	nil
4. Total cost of production	50	50	50	50	50	46
5. Profits before income tax (PBT)	50	50	50	50	50	54 (Enterprise's inherent profit)

In any of the first five years, then, the licensor's (foreign

firm's) share or proportion of the enterprise's inherent profit (LSIP)^{65/} the fraction:

$$LSIP = \frac{4}{54} = \frac{4}{50+4}$$

or, rewriting this formulation algebraically:^{66/}

$$LSIP = \frac{R}{(PBT)_1 + R} \quad \dots\dots\dots \text{Equation I}$$

where $(PBT)_1$ ^{67/} is the profit-before-tax during the royalty period and R is the absolute royalty amount (not rate) payable to licensor.

The local firm's share (enterprise's share - ES) of income is correspondingly:

$$\begin{aligned} ES &= 1 - (LSIP) \\ ES &= 1 - \frac{R}{(PBT)_1 + R} \\ &= \frac{(PBT)_1}{(PBT)_1 + R} \quad \dots\dots\dots \text{Equation II} \end{aligned}$$

It is to be noted that this 'share': (1) refers to the share in the profit before corporate tax is paid and (2) holds only during the royalty-bearing period.

^{65/} LSIP is read as 'Licensor's Share of (enterprise's) Inherent Profit'.

^{66/} Equation I can be simplified to

$$LSIP = \frac{1}{1 + \frac{(PBT)_1}{R}} \quad \text{where } (PBT)_1 \text{ and } R \text{ are}$$

absolute values.

^{67/} The general way PBT is derived is shown in Table 2 Section I.

For illustration of its practical usage let it be supposed that the following situation held during a particular year of the royalty-bearing period:

Net sales value of enterprise	-	\$155,000
Royalty payable to licensor	-	\$ 5,500
Profit before tax (PBT ₁)	-	\$ 45,000

Then from Equation I, the licensor's share of the firm's inherent profit (LSIP) is

$$\begin{aligned}
 \text{LSIP} &= \frac{R}{\text{PBT}_1 + R} \\
 &= \frac{5500}{45000 + 5500} = 10.9\%
 \end{aligned}$$

for that particular year.

Correspondingly, if only the Enterprise's share of profit is to be determined (Equation II):

$$\text{ES} = \frac{\text{PBT}_1}{\text{PBT}_1 + R} = \frac{45000}{45000 + 5500} = 89.1\%^{68/}$$

The term 'inherent profit' is a conceptual construction in this analysis. It is unknown to conventional accounting.

^{68/} If, in this illustration, PBT₁ happened to be \$ 30,000 instead of \$ 45,000, LSIP would be $\frac{5500}{30,000+5500} = 15.5\%$ and

ES = 84.5%. In other words, in a low-profit situation (profits to sales of $\frac{30,000}{155,000} = 0.194$ instead of

$\frac{45000}{155,000} = 0.290$), the licensor obtains a greater share of the enterprise's inherent profit.

(Conventional accounting will treat royalty as a cost like interest cost or raw materials cost). This situation, however, does not mitigate the use of 'inherent profit' as an analytical tool ^{69/},

In many developing countries, average LSIP varies over a limited range and would typically be below 25%.

In actual practice, 'R' and 'PBT' would be the sum of their respective npv's (see page 142) for the years during which royalty will be paid. For illustration, the following (Table 9) would be a more realistic appraisal.

It is to be noted that PBT_1 is not independent of R; if, for a given situation, R is changed, PBT_1 will also be changed ^{70/}.

The basic utility of Equation II is to examine the implications of two or more licensing proposals. For example, if the national entrepreneur had to choose

^{69/}In 'inherent profit' royalty is added back to PBT. PBT and R are conventional accounting terms.

^{70/} If all production cost factors and sales figures remain the same and only R is changed to R_1 , the new LSIP is calculated by the expression:

$$(LSIP)_{New} = \frac{R_1}{PBT_1 + R}$$

Table 9

Income Share Determination using Discount Factors

Unit: 000 dollars, Eng-of-Year

payment

	<u>Royalty-bearing period</u>				
	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Net sales value	1200	1400	1800	2500	4000
Royalty at 3% of sales (undiscounted)	36	42	54	75	120
Profits-before-tax (Undiscounted), PBT ₁	(150) ^{71/}	0	450	600	1300
Discount factor	1.1	1.21	1.33	1.46	1.61
npv of discounted royalty ref. to year '0'	32.7	34.7	40.6	51.4	74.5
npv of PBT ₁	(136.4)	0	338.3	410.9	807.5
npv of R	-----233.90-----				
NPV of PBT ₁	-----1420.3-----				
ES	= $\frac{PBT_1}{PBT_1 + R}$		= $\frac{1420.3}{1420.3 + 233.90}$		
	= 0.85 (or 85%)				

^{71/}() indicates loss

between two technologies, whose R and PBT_1 were as follows:

	<u>Basis - Technology X</u>	<u>Basis - Technology Y</u>
Net sales value	\$ 1,400,000	\$ 1,400,000
Total fixed investment	\$ 1,600,000	\$ 1,600,000
NPV of Royalty (10 year term)	\$ 45,000	\$ 62,000
NPV of profits before tax (PBT_1)	\$ 380,000	\$ 410,000

The national entrepreneur would be likely to choose Technology X because the enterprise's share (ES) of 'inherent profit' is the greater, viz.

$$ES = \frac{380,000}{380,000 + 45,000} = 0.8941 \text{ (Technology X)}$$
$$ES = \frac{410,000}{410,000 + 62,000} = 0.8686 \text{ (Technology Y)}$$

The expression 'likely to choose' is used since an entrepreneur would be interested in evaluating both 'share' and the absolute level of profit. Further, he would also examine his profit income after the royalty-bearing period is over. Consideration of these factors may cause him to reverse the above indicated decision.

Governments of developing countries, however, may be more inclined to view alternate technology proposals (or differing terms applying to the same technology) relative to the fraction of profit going to the enterprise (or

licensor) rather than its absolute amount.

B. Case of Joint venture with Royalty Payments

As said before, when the national enterprise is a joint venture, and it pays a royalty (over the royalty-bearing period) to the foreign venture partner (FVP), then the FVP receives two streams of income: (1) dividends, from his position as shareholder - a division of the firm's after-tax profit - and (2) royalty - payment for the use of his technology.

Table 10 is a rework of Table 8, assuming: (a) the same royalty rate (4% on sales) and royalty period (5 years) (b) the FVP has 60% of the enterprise's equity and (c) the rate of corporate tax is 40% applicable on profits-before-tax for all years. It is additionally assumed that in the sixth year, the FVP's equity in the firm is phased out and consequently neither royalty nor profits are payable to him.

Thus in the 6th year, we obtain a view of the 'enterprise's inherent profit'. This is "32.4" in Table 10 (line 7). Profit flowing to the National Venture Partner, during the joint-venture/royalty-bearing period is "12".

Table 10

Income-Share of National Venture Partner (NVP)
in Joint Venture associated with Royalty Payments

Basis: Currency Unit

	<u>Year 1</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6</u>
1. Net sales value, units	100	100	100	100
2. Cost of production excluding royalty	46	46	46	46
3. Royalty payable to foreign venture partner (FVP)	4	4	4	nil
4. Total cost of production	50	50	50	46
5. Profit before income tax, PBT	50(PBT ₁)	50(PBT ₁)	50(PBT ₁)	54
6. Corporate tax at 40%	20	20	20	21.6
7. Profit after tax (of enterprise)	30	30	30	32.4 ^{72/}
8. Distributed and paid out profit of enterprise (assumed)	30	30	30	32.4
9. Profit flowing to foreign venture partner (60/40 majority holding)	18	18	18	nil
10. Profit flowing to national venture partner	12	12	12	32.4

^{72/} This is the enterprise's 'inherent profit' since, as assumed, from the 6th year there is neither a royalty payable to, nor is profit shared with, the foreign firm.

Consequently, the share of the National Venture Partner (NVP) of the enterprise's (inherent) profit, $(EP)_{NVP}$, is $12 \div 32.4$. (It is important to note that the shared profit being considered in this case is the profit-after-tax, PAT).

The algebraic expression for '12', the profit flowing to the national venture partner, is :

$$\left[(PBT_1) - (PBT_1) \times (\text{Tax Rate}) \right] \times (EF)_{NVP}^{73/}$$

where

PBT_1 = profit-before-tax during the joint venture/
royalty period, $(EF)_{NVP}$ = Equity Fraction of the National Venture Partner in the enterprise during the joint venture/royalty period

or

$$(PBT_1) \times (1 - \text{tax Rate}) \times (EF)_{NVP} \quad - \text{Expression A}$$

Correspondingly, the algebraic expression for '32.4', the 'inherent enterprise after-tax-profit' is:

$$\left[(PBT_1) + R \right] - \left[(PBT_1) + (R) \right] \times (\text{Tax Rate})^{74/}$$

or

$$(PBT_1 + R) (1 - \text{Tax Rate}) \quad - \text{Expression B}$$

^{73/} From Table 10, $(50 - 50 \times 0.40) \times (0.40) = (50 - 20) \times (0.40) = 12$

^{74/} From Table 10, $(50 + 4) - (50 + 4) (0.40)$
 $= 54 - (54) (0.40) = 54 - 21.6 = 32.4$

Hence the fraction of the enterprise profit flowing to the National Venture Partner during the joint-venture/royalty period is:

$$= \frac{\text{Expression A}}{\text{Expression B}}$$

$$= \frac{(\text{PBT}_1) (1-\text{Tax Rate}) (\text{EF})_{\text{NVP}}}{(\text{PBT}_1 + \text{R}) (1-\text{Tax Rate})}$$

or

$$(\text{EP})_{\text{NVP}} = \frac{(\text{PBT}_1) (\text{EF})_{\text{NVP}}}{(\text{PBT}_1 + \text{R})} \quad \text{- Equation III}$$

where $(\text{EP})_{\text{NVP}}$ is the share of the National Venture Partner in the post-tax profit of the enterprise (EP= Enterprise profit) during the joint-venture/royalty period ^{75/}

It may be noted that in Equation III, $(\text{EP})_{\text{NVP}}$ is independent of corporate tax rate (so long as the rate is unchanged over the period subjected to analysis) ^{76/}

^{75/}

The whole of the balance $(1-(\text{EP})_{\text{NVP}})$ does not go to the Joint-Venture Partner. A small fraction of it

$$= \frac{(\text{R}) (\text{Tax Rate}) (1-\text{EF})_{\text{NVP}}}{(\text{PBT}_1 + \text{R})}$$

goes to the government as tax. Because of the need for this adjustment, the national partner's assessment is best met by evaluating Equation III.

^{76/} Inspecting Table 10, it will be seen:

JVP's share of firm's profit-after-tax income during the joint-venture/royalty period	= 18 currency units
Government's share of firm's income over that period	= 20
Local venture partner's share of post tax income	= $\frac{12}{50}$

where '50' units is the PBT_1 of the firm during the period.

Illustratively, if the following data held for an enterprise in joint venture:

1. National Venture Partner's (NVP) equity = 30%
2. Royalty payable by enterprise to foreign venture partner on operations in year 1983 = \$ 14,500
3. Profit-before-tax (PBT₁) for 1983 = \$108,000

Then the share of the National Venture Partner(NVP) in the inherent profit of the enterprise in 1983 is (applying Equation III):

$$\begin{aligned} (\text{EP})_{\text{NVP}} &= \frac{(108,000) \times (0.30)}{(108,000 + 14,500)} \\ &= 0.264 = 26.4\% \text{ }^{77/} \text{ (Note: after-tax basis)} \end{aligned}$$

Equations I and III are, again, evaluatory tools for national entrepreneurs useful for options during negotiations with venture partners. In Equation III it must be noted that while the terms on the right hand side of the Equation are of conventional accounting practice, the result, giving a fraction of inherent after-tax profit, is unconventional, and merely an evaluatory tool. ^{78/}

^{77/} If, instead of \$ 108,000, the profit of the enterprise was \$ 75,000, (EP)_{NVP} works out to 25.1%. Thus, at lower profitability, as in the case of direct licensing, the share of the national entrepreneur reduces. However, since in this evaluation we are considering division of after-tax profits, the effect of the reduced share is not very significant.

^{78/} Rigorous analysis using standard accounting practices will yield the same comparative basis.

The use of Equation III to analyse options to the national venture partner is illustrated in the following example:

Table 11

Distribution of Income in a Joint
Venture Involving Royalty Payments

<u>Situation</u>	<u>Option A</u>	<u>Option B</u>
1. National Venture Partner's Equity Fraction, (EF) _{NVP}	0.30	0.35
2. Royalty payable to foreign venture partner over a ten-year term of the Royalty Agreement, NVP basis, (R)	\$14,500	\$17,000
3. Profits-before-tax of the enterprise over the term of the Royalty agreement, NPV basis, (PBT ₁)	\$112,000	\$108,000

Evaluation:

$$\begin{array}{l} \text{Share of National venture} \\ \text{Partner in the Enterprise's} \\ \text{Inherent Profit} \end{array} \quad \begin{array}{l} \frac{(112,000)(0.30)}{(108,000+14,500)} \\ \\ = 0.266 \end{array} \quad \begin{array}{l} \frac{(108,000)(0.35)}{(108,000+17,000)} \\ \\ = 0.302 \end{array}$$

showing that Option B would be likely to be preferred.

The expression 'likely to be preferred' is employed once more to indicate that there may be other financial and non-financial considerations in the decision-making process.

Likewise, it should be noted that R and PBT₁ are not independent terms under each of the options, and that changing R will change PBT₁.

In deriving Equation III it was assumed that the foreign joint-venture partner was 'phased out' in the 6th year. This assumption does not affect the validity of Equation III even if the joint venture was not so terminated. The 'phase out' assumption was made merely to obtain a concept of the firm's inherent after-tax-profit.

It would be useful to note that in calculating LSIP by Equation I, or $(EP)_{NVP}$ in Equation III, very precise definitions and calculations of PBT_1 are not necessary. For comparisons of alternatives, it is only necessary that PBT_1 be derived in a systematic matter.

THE EQUITY RATIO

As said earlier, there is no objective arithmetic that will determine an appropriate equity ratio for a joint venture. The equity ratio, when it finally emerges from the negotiation process is a composite response to the consideration of various matters:

- the control which the partners wish to exercise over the decisions of the company
- absolute levels of profits expected by the partners and the division of profit
- the incremental degree of risk one of the partners will bear
- government policies

- the maximum equity that one of the partners will contribute
- the foreign exchange needs of the project over that available from lending agencies, etc.

The equity ratio is, however, not very important in certain areas of concern.

As can be seen from Table 7 (stock issuance), the equity ratio would not be a very important deliberating point if it is solely sought as a proportioning, or adjusting, device for profit distribution. In other words, a non-controlling partner can obtain, if he wishes, more than 50% of a company's distributed profits by holding corresponding level of non-voting stock.

Likewise with management. As discussed in Section IV, a partner without a majority stock holding may be able to negotiate a dominant role in management (as the foreign venture partner often does). In very many developing countries, indeed, the Governments will leave it to the partners to make the related decisions^{79/}. Consequently, the equity ratio is seldom negotiated on considerations of proportioning management powers.

To a limited extent, the equity ratio - the ratio of voting stock - will be negotiated on expectations of absolute levels of profit. For instance, one of the partners may

^{79/} In certain national legislations (e.g. Spain) the partner with controlling stock may be required to have a dominating position in management (e.g. through proportional appointment of Directors).

not be interested in a venture if it does not promise to bring him a certain level of profit. This level of profit, perhaps, will only be obtainable if he holds at least 40% of equity. At this level, the 40%-partner is unlikely to be opt for a situation in which most of such income will come from non-voting equity stock. He may consequently negotiate for all 40% to be voting stock or will set a minimum that, at least, 35% or so of such stock should have full voting rights.

Similarly, within limits, the equity ratio can also be influenced by the greater confidence of one of the partners. For example, the national partner may believe that product offtake will increase at a faster rate than is the opinion of his counterpart; thus opinion that a larger plant should be built. He may, therefore, be prepared to accept a higher level of risk by providing incremental equity funds for the larger plant.

Threshold Ratios: Control, through division of voting power is, however, the most important determinant of the equity ratio.

By failing to own a majority of the stock, or as will be discussed shortly, certain levels of 'threshold stock', a partner may not be able to significantly or even partially determine the way his invested funds will be utilised.

Consequently, in negotiating the equity ratio, the partner will essentially be negotiating a division of voting stock.

Within an environment - the socio-legal ambiance of a country - there are usually certain 'threshold' equity ratios. Some or all of the following ratios may apply to the environment: 10%, 25%, 51% and 75%. These ratios relate to certain specific rights that the shareholder owning such percentage can legally have in commercial codes (company law). As pointed out in Section IV, the 10% ratio may give the partner the right to requisition company meetings if he feels the company is being mismanaged; the 25% ratio may enable the shareholder possessing such a level of voting stock to block ('veto') the passing of 'special resolutions' which may be required to be passed (by provisions in the bye-laws) on certain key decisions of the company, say, disinvestment of fixed assets; 51% ownership may give its owner full control over most matters of the company ^{80/} and 75% ownership of stock may give its holder virtually absolute control of the company.

^{80/}

A major reason behind transnationals wanting a 51% share is that it enables them to consolidate the accounts of the 51% 'subsidiary' with the accounts of their main operations, and thus obtain a high international ranking. Laws in many industrialised countries do not permit consolidation of a subsidiary's accounts unless equity holding therein exceeds 51%.

Within the environment there may be also other thresholds such as 35%, 40%, 49%, 51%, etc. For illustration, in certain industrial sectors foreign ownership may be limited by legislation (e.g. to 34% for mining investments in Mexico); in other cases, trading or other privileges given to 'national' and 'foreign' companies may be equalised if foreign holdings were below a certain percentage (i.e. 40% and below in India), etc. Likewise, it may be a legislative requirement that foreign ownership of equity - the control of voting stock - be less than 49% or that of national ownership be "not less than" 51%, etc ^{81/}

Bye-law Linkage: The equity ratio will usually be negotiated linked to provisions of proposed bye-laws. For illustration, if the national entrepreneur can successfully negotiate that the bye-laws will provide for the exercise of special resolutions (say, voting by three-fourths majority) on issues of vital interest to him (say, the debt-equity ratio), he may be quite willing to have the foreign partner own up to 74% of the firm's equity. Similarly, if the foreign partner concerned with management rights, could negotiate that the bye-laws will provide for the election of all the

^{81/} Many transnational companies have thresholds of 25%, 30% etc below which they will not permit the joint venture to use their corporate name or trademarks. Conditions to this effect may be built into the bye-laws of the joint-venture company.

directors by a simple majority, he may be willing to limit his equity to 51%. Likewise, in a three-party joint venture, the partners may arrange so that each has, at the minimum, a blocking vote on issues vital to them; or that two of them jointly have that amount of stock that will enable them, should they wish to act together, to ensure the passage of statutorily required special resolutions; etc.

THE DETERMINATION OF PROFIT

The equity ratio importantly determines how the post-tax profit of the joint-venture company should be divided among its shareholders^{82/}. However, more often than not, little attention is paid in the negotiation process to the factors that determine the formula for profit. For example, a low rate of depreciation (or deferred depreciation) will enhance the profit of a company. This may be insisted upon by the foreign partner. Likewise, if the company does not carry out R & D - which may be essential to its long term survival - its profit may be unrealistically enhanced. Still again, if the foreign investor supplies some input, and is in a position to unilaterally determine its price, the profit of the enterprise may be low. This may act to the sole disadvantage of the national partner's share.

^{82/} In some instances, decidedly rare (example, U.S. oil exploration ventures) division of profit may not be directly proportional to share investment (equity contributions):

Because of the complexity of industrial activities in general, and possible complexity within an enterprise (involving, say, domestic and export activities), there is no unambiguous way to define "profit" which will hold for all companies. For this reason, even national taxation authorities permit a degree of latitude in deriving the figure for profit. Consequently, while the national partner should sensitize himself to facets that determine profit, he may be limited in his capacity to negotiate a formula for profit determination and its sharing.

At the same time, however, a formula should be negotiated which would determine how much of the firm's profit should be ploughed back (to create reserves; for the growth of the enterprise, or as a bulwark against an unfruitful future year).

RAISING DEBT CAPITAL

All financing falls within the alternatives of three principal categories:

1. self-financing vs external financing
2. debt-financing vs equity financing
3. local financing vs foreign financing

In developing countries, where there is usually some form of governmental control on flows of national and foreign currencies, very wide options may not be available.

The overall debt that a national enterprise will need to raise will basically depend on: (1) the capital needs of the project (2) the availability of equity funds from the partners and associates (3) national policies on debt/equity (D/E) ratios and (4) business variability^{83/}

The possibility of 'self-financing' - from depreciation and retained profits - will hardly arise in the case of a new venture. Self-financing by way of investments from affiliates of the partners, or from the sale of the foreign partner's parent company stock in the national capital market (to raise equity funds), may be limited to very few developing countries. By and large, external financing will be the most prevalent method.

In the context of the developing country, again, the possibility of obtaining equity funds from the general public or from investment banks (q.v.) will be restricted to large ventures: even so, only when such ventures are launched by promoters who have earned their reputations in other successful projects. Very substantially, therefore, the new venture will have to depend for its equity on the partners, and to a limited extent, on developing banks.

83/

A joint venture must evaluate its strategic 'staying power' - its ability to weather and recover from unpleasant business surprises. The enterprise should consider what additional resources it can tap should things go wrong.

In many circumstances debt will be favoured to equity even if equity funds were available. Firstly, in most national tax systems dividends paid by the enterprise on equity funds cannot be deducted from the gross profit of the firm; but interest on debt can be. Thus, if the market rate of interest is 10%, and corporate tax 50%, the enterprise will have to make a gross profit amounting to 20% on its equity capital to pay the equivalent sum (10%) to the equity holder. (In fact, the profitability will have to be substantially higher since an equity-holder will expect a compensatory rate of return because of the greater risk he exposes himself to). Secondly, long-term debt enables a company to make money on other people's funds without loss of ownership control.

Types of Debt Capital

In the circumstances the D/E ratio proposed for the enterprise is within the range of industry norms and government policies, it should be possible for it to raise various kinds of debt. The overall 'debt portfolio' (debt-mix) of the enterprise will emerge from considering: (1) the prevalent forms in which debt is, or can be, raised in the general environment (2) the costs of various kinds of debt capital (3) availabilities of debt capital (4) exchange

regulations, etc. It is important to note that while it is the enterprise that incurs the debt, the promoters of the enterprise will often have to act as its guarantors (q.v.). Thus, the raising of debt has many dimensions.

For the purposes of the discussion here, debt financing can be taken to comprise of two components: short-term debt, usually for working capital, and long-term debt for financing fixed assets.

Short-term financing, while important, and often a source of great concern to the fledgeling organisation, is not a major issue in floating a joint-venture enterprise. Short-term loans are typically obtained from 'commercial' or 'clearing' banks against hypothecation of stocks, straight overdraft, bill discounting, 'commercial paper', etc. Often, banks will 'rollover' these funds to keep the enterprise's cash needs met.

The availability and use of long-term loans - often called the 'debt capital' of the enterprise - will be a major issue in deciding the organisation of the capital of the enterprise. The partners will have to do many 'exercises' before they can establish its ultimate debt-mix.

Debt capital would be available to the developing country enterprise from two sources: (i) the 'capital markets' of the commercial community operating under strict demand/

supply forces and (ii) promotional loans ('soft loans') from 'development banks' and agencies oriented to investments in developing countries. The ability of the enterprise to raise such loans depends on the national and inter-national reputations of the partners; the perceptions of the loaning organisations on the desirability and viability of the intended project ^{84/}; the political views of those who will loan the funds; etc.

Long-term loans can vary anywhere from 8-20 years in duration for industrial concerns. Development banks will probably be the predominant source of long duration loans and the commercial capital markets for those of the medium period. The loaning organisations may be national, regional or international. Currency of loans could be national or foreign but enterprises can be expected to maximise the use of local funds to avoid exchange fluctuations.

Loans from commercial capital markets

Investing entities (wealthy individuals, private estates, pension funds, etc) in the capital market make funds available to industrial enterprises both directly and

^{84/} Every lender has to take two decisions (a) the 'investment decision' - whether to fund the project at all and (b) if fundable, the 'financing decision' - the terms under which the funds should be lent such that the borrower is unlikely to default on interest and instalments.

indirectly (through intermediaries) but in all cases the borrower stands identified. Direct loans involve agreements with commercial banks and are usually offered at a variable rate of interest linked to some 'standard' like the London Interbank Offer Rate (LIBOR). Bonds and debentures, on the other hand, constitute fixed rate finance (e.g. the issue of 8 $\frac{1}{2}$ % 1992 Asiabonds), the interest rate commercially labelled the 'coupon rate'^{85/}. While quite similar in nature, debentures are generally raised in the national capital market while bonds can be raised both nationally and internationally (e.g. Eurodollar bonds). Bonds and debentures are denominated (e.g. \$ 500 debentures), numbered, 'engraved' certificates identifying the borrower and stating his pledge to pay interest and redeem capital. Like common stock (shares), bonds can be registered bonds or bearer bonds. In all cases, bonds and debentures are negotiable instruments. Both the securities have fixed maturity (e.g. a 8-year debenture). The borrower may elect to 'redeem' (encash) his bonds/debentures either at the end of the maturity period or at some electable earlier date specified in the bond. In recent years, bonds with a variable rate of interest have been offered.

^{85/}The bond-holder usually receives his interest against submission of matured interest coupons which are attached to the bond certificate.

In raising funds through bonds and debentures there is almost always a financial intermediary between borrower of funds and the lenders. The intermediary can be a financial subsidiary of one of the partners, an investment ('merchant') bank, an underwriting syndicate or other similar institution.

In arrangement with the intermediary - say, the investment bank - the enterprise will 'float' the bond or debenture. The investment bank may purchase the whole of the bond issue or part of it. Where the latter applies, it may 'underwrite' (singly or together with an underwriting syndicate) the balance of the issue, agreeing to purchase that part which cannot be immediately marketed. The investment bank may then 'place' the bond privately or in the open commercial markets. In placing the bonds, the investment bank may use a 'selling syndicate'. The ability of the enterprise to successfully float a bond issue (sell bonds to investing entities in the capital market) depends on both its own reputation and that of the investment bank.

Debentures and bonds are usually secured against immovable property of the borrower - land, buildings, equipment. Invariably, a debenture or bond 'trust' will be created and it will obtain the lien on the property. The conditions under which the enterprise borrows the funds will be expressed in a contract ('indenture') between the enterprise and the trust company. The enterprise will periodically pay

in certain sums of money to the trust - to the 'sinking fund' - from which the debt will be retired.

The mediating investment bank or underwriting firm can be expected to place certain conditions on the operating flexibility of the enterprise. These may appear as intrusions into the management rights of the enterprise. Conditions may entail limits on further borrowings; on the expansion of facilities through fresh investments; the level of dividend declarations, the maintenance of minimum current ratio; the disposability, or transfer, of the equity shares of the partners, etc. These are collectively called 'negative pledges and covenants'. Such covenants are not particular to bond/debenture issues and will apply to other borrowing instruments (such as 'straight loans' from commercial and development banks).

Additionally, in their own identities, the partners may have to guarantee such loans. Where this is called for, it would be usual for the foreign partner to guarantee international borrowings and for the national partner, national borrowings. Often, development banks (q.v.) may be willing to provide the guarantees to the loaning agencies.

Compared to straight loans, the major advantage of bonds/

debentures is their fixed interest rate^{86/}. Their disadvantages are:

(i) there is an intermediary, and therefore, both brokerage and service costs will have to be paid (with such costs often being substantial)

(ii) no flexibility is available for rescheduling interest and debt repayments

(iii) governmental rules and regulations will have to be followed in offering public issues of such securities, and

(iv) considerable 'paperwork' is involved in maintaining registers of bond holders, in making payments of interest and debt instalments, etc.

While the developing country enterprise, in the early years, is unlikely to directly raise debt through bonds, it should be noted that the partners may raise such debt by virtue of their other operations. It would not be unusual, for instance, for the foreign partner to supply equity to the national enterprise through internationally borrowed

^{86/} Although when placed internationally, currency fluctuations will have to be reckoned with.

funds (say, Eurodollar loans or the flotation of Eurobonds)^{87/}

Development Banks as Sources of Finance

One of the major sources of funds for developing country enterprises, today, or for those participating in developing country enterprises, is the institution of development banks. The stature of these banks can be international (the International Finance Corporation of the World Bank Group that lends to the private sector), regional (the Andean Development Corporation) or national (the 'financieras' of the Latin American countries). Development banks are promotional agencies which offer 'soft' loans for investments in developing countries (concessional loans with low interest rates; long-period debt retirement schedules; 'grace period' before first payments of interest and repayments of loan capital; low service costs, etc). Development banks are, in themselves, funded by governments of participating countries.

^{87/} Eurodollars, (Euromarks), etc. are national currencies of the USA, FRG, etc which are maintained outside the borders of the country in which they were first issued. Deposits and loans of Eurodollars are managed by an international syndicate and the deployment of the funds is not subject to national regulation (reserve ratios, interest rate ceilings, etc). Such currencies (and loans in such currencies) are freely available in all countries where they are no foreign currency regulations. Eurodollar bonds (Eurobonds) are placed through banks which are affiliated to the aforestated international syndicate.

Development banks have also been created by developed country governments (e.g. Agency for International Development, AID, of the USA; Commonwealth Development Corporation of the UK; etc) which promote the setting up of enterprises in developing countries but in which there are creditor country investors (i.e. American, British corporate investment).

A significant form of assistance that such banks offer, apart from that of direct loans, is that they often underwrite equity issues made by the developing country enterprise, guarantee loans taken by the enterprise from other lending agencies (say, a US commercial banks) and underwrite bond flotations by the national firm, etc. These latter forms of assistance have substantially replaced the need for 'parent company guarantees' - the foreign partner guaranteeing loans taken by the national venture.

Many banks will provide equity funds to an enterprise if a development bank is an investor. This is termed 'co-financing'.

The debt portfolio

As discussed earlier, the overall debt requirements of the enterprise will arise from considering the extent to which the partners and others will provide equity to the firm.

Once this is established ^{88/}it will be possible to examine the forms in which debt will need to be raised. As can be expected this will, in the general case, not be at the sole discretion of the partners. Lenders will want to know the nature of intended operations, and critically, of its forecasted 'cash flow' position.

Where interest and loan redemption involve payments in foreign currencies (for example, for imported equipment), national governmental policies and approvals will determine the extent to which foreign loans (including possibilities such as 'supplier credits' offered by foreign equipment manufacturers) can be entertained and serviced. When there are such governmental restraints, the national loan markets will have to be approached.

In the absence of the latter restraint, the partners will have to consider the following factors in arriving at the debt-mix of the enterprise:

(i) costs of the various forms of debt: 'market rates (interest rates and period) for debentures and bonds; cost of floating bonds (underwriting and placement charges); risk in variable-interest rate loans from banks, etc.

^{88/} In the actual situation, debt and equity proposals of the firm will be considered together by the loaning agencies.

(ii) loan covenants and guarantees - conditions imposed by lenders

(iii) the cash flow position of the company and thus its ability to meet on time obligatory payments to lenders

(iv) whether the enterprise will be able to provide the security needed by lenders, i.e. pledge its machinery, land, etc

(v) international currency fluctuations and inflation as they will affect foreign currency needs, increase debt servicing costs, etc.

Because of the many complexities of raising debt, it will generally not be possible for the partners themselves to develop the most appropriate debt-mix. It would be normal for the partners to meet with the advisory services departments of investment and development banks to arrive at the optimum debt portfolio, and to use the banks, indeed, to raise the debt.

SECTION VI

NEGOTIATING THE TRANSFER OF KNOWHOW AND TECHNOLOGY-RELATED SERVICES (THE JOINT-VENTURE CONTEXT)

INTRODUCTION

The issues and dimensions of a transaction concerning the transfer of technology to a joint venture are more complex and less visible than those involved in direct licensing. Belated, a national partner can find licensed technology too restrictive in scope, excessive in cost and disproportionate to the quality of his investment. This situation is largely due to inattention paid to technology in the process of negotiating joint-venture arrangements and to the overcapitalisation of technology and technology-related services by the supplier of technology.

Three factors, in turn, account for this. First, management and capital arrangements tend to dominate the attention of the partners in the process of negotiation, subordinating technology-related matters. Second, arrangements concerning the transfer of technology are liable to be dispersed among several agreements diluting focus on significant issues. Third, the main

joint-venture agreement (see Section VII) and the associated technology agreements are not kept complementary.

When the purpose of an international transaction is direct access to technology - the straight-forward licensing of technology - the recipient of technology should be careful on what he is negotiating. If through misjudgment or inexperience the national entrepreneur (licensee) acquires a wrong, or inappropriate technology, or he cannot achieve the benefits of its intended use, he seriously endangers his investments. It may be noted that in the general case the cost of technology is only a small fraction of total manufacturing investment. Even if the licensor could be held liable for incorrect or deficient sale of technology, his financial responsibility will generally be no greater than the cost of the license. Thus, the careful entrepreneur, to protect his substantial investment in the physical plant, exerts himself to obtain a clear conception of the nature of technology which will be transferred.

However, when the entrepreneur enters into a joint venture with a reputable owner of technology he, of course, reduces chances for such misjudgment. If the transferred technology, perchance, fails to perform to expectation,

the foreign partner can be expected to correct it. If he does not do so, he too risks poor return on the investments he has made. Thus, the self-interest of the foreign partner often provides the needed security for the national entrepreneur.

While, certainly, such consideration is the reason for the popularity of the joint venture in developing countries, it nonetheless frequently happens that the final realised venture is a much truncated, and a sub-optimal, version of what the national entrepreneur expected: neither is the capability of the physical facility as wide, or as flexible, as anticipated nor, as stated earlier, is the reward to the entrepreneur - his share of profits from the venture - commensurate with the quality of his investments (cash inputs in most situations).

For example, even though in the main joint-venture agreement the purpose of the transaction could be stated as the "manufacture of product X", the physical facility, when it finally emerges - from the foreign partner's endeavours - might only be a 'finishing' unit (adding some small amount of value to imported inputs) and not a 'manufacturing operation' as the co-partner anticipated.

Likewise, while the agreement may read that the payment for the "technology" would be a certain sum, it could finally happen that the payment was merely for technical

assistance (q.v.), which, as will be discussed, could have been obtained at a more competitive price from a third party, without harm to the main objectives of the joint venture or to the reward expected by the foreign partner.

Such situations can be avoided or minimised by: (1) clear recognition of the terminology used in connection with the transfer of technology to a joint-venture company (qualitative differentiation of inputs) (2) quantitative differentiation of the inputs and (3) avoiding premature execution of the main joint-venture agreement without adequate protection in the licensing agreement(s).^{89/}

Inattention to technology generally leads to the following problems:

(1) poor definition of the accountabilities of the foreign partner in the supply of his contracted inputs

(2) overpricing of technological inputs, and as earlier expressed, consequent overcapitalisation of the foreign partner's contributions

^{89/}Very often this particular sequencing arises from procedural requirements of developing country governments.

(3) as will be discussed, the joint-venture enterprise making, in effect, duplicative payments for essentially the same services

(4) overdependence on foreign inputs and, at times, an expensive dependence

(5) inflexibilities when the technology agreement needs to be renewed after its initial term lapses, etc.

The compensation to the foreign partner for technology-related inputs - in cash or kind (capitalisation) - is the subject of this Section and covers inputs as technology, technical assistance, technical services, machinery and equipment, management services, pre-investment services and special services.

TECHNOLOGY AND TECHNOLOGY-RELATED SERVICES

The essential subjects of the main joint-venture agreement are capital, management and control of the joint-venture company. In this agreement, 'technology' and 'technology-related services' are introduced only to serve the limited purposes of: (i) indicating the goals of the venture in relation to which the joint-venture arrangement is formulated, and (ii) enabling the capitalisation of technology and technology-related services. Definitions and descriptions of

technology and technology-related services are usually covered in associate agreements (as the licensing agreement).

Consequently, if the main agreement is approved or executed before the associate agreements (particularly, the licensing agreement) have been discussed, the negotiating ambit of the national entrepreneur is constrained in the latter. In such sequence, whatever is dealt with in the associate agreements is merely supportive of the main agreement. No leeway would be available to the national partner to build in safeguards in the later agreements. For instance, if in the main and executed agreement the purpose of the venture was stated, without further qualification, as the "manufacture of automobile rear axles", the foreign partner may not permit, if he did not originally so intend, subsequent enlargement of venture objectives in the license agreement. Thus, it may not be possible at this stage, for the licensee to define "technology" (in the license agreement) as that pertaining to a particular set of 'starting materials', say, basic steel stock instead of the imported forged axle blanks as intended by the licensor.

Consequently, the joint-venture agreement should refer to the licensing agreement(s) if technological inputs are divided and separated in the two agreements.

'Technology', 'Technical Assistance' and 'Technical Services'

It is not the purpose here to provide legal definitions to technological inputs or to discuss what legal safeguards should be applied to warrant that contracted transfers will take place ^{90/}--. The objective here is to examine the substantive elements of the technology package - technology and its associate services - and to relate them to the flexibility that might be sought by the national partner in a joint venture.

"Technology" may be viewed, from the point of view of its licensing, as that irreducible sum of information, data, techniques and skills which an enterprise must procure from a qualified source to be able to produce a designated specific product (say, rear axles for a CITROEN) or to perform a technological service (say, anodising of aluminium profiles). It is a unitary package that cannot be readily disassembled into its constituent elements and be purchased from independent competitive sources. The integrity of such a package may arise from the level of its sophistication, its protection through patents and trademarks and/or from the secrecy with which its 'recipes' are held. This input has to be compulsorily obtained from the licensor.

^{90/}--Covered in DIT-12

If the entity acquiring this information - including the joint-venture enterprise under consideration - was proficient in its capability to handle related technical and managerial inputs, it should either be possible for it (the entity itself) to translate licensed technology into a manufacturing operation, or to acquire implementation inputs from third-party professional organisations.

That is, it should be possible for the national firm to tender for the engineering, procurement and construction services, to obtain competitive bids, and to make its selection (collectively referred to as 'unpackaging'). This is precisely how, for example, chemical or metallurgical technology is handled in the industrialised countries. The firm acquiring technology selects (and pays) its own engineering and construction contractors, and the latter, with minimal contact with the licensor-owner of technology, will put the technology into practice (build the plant).

Loosely, these supportive services are called 'technical services'. Correctly, the term is a divisible composite of 'technical assistance' and 'technical service'.

"Technical assistance" is accorded to all such functions as will involve the planning and layout of physical facilities, the design of hardware and equipment, procurement, erection, and the commissioning of the plant. Technical

assistance is a 'one-time' service. It can be disaggregated into its components - design, procurement, construction, etc. These need not be obtained from the same supplier. Independent firms can work together and put together a viable working plant. Consequently, each component of service can have its distinct price and a precise accountability. It is only for convenience that the national enterprise selects the technology owner as a supplier of this set of services and as its manager.

Technical service is a third technology-related input. While, theoretically, it should be possible for a capable licensee to commission and operate a manufacturing facility based on the technology package from the licensor - which, indeed, is how "technology" is legally defined in licensing agreements^{91/} - the licensee, even the advanced, often requires guidance from the licensor. He will require help, for example, to train his technical staff, to set standards for raw material purchases, to approve suppliers, to maintain the effective working of a plant through periodic check-ups, to 'trouble-shoot', to set up quality control and inspection procedures, to help solve product-user problems, etc. These are 'continuing' services and generally services

^{91/} See DIT-12, page 13.

which cannot be readily provided by third parties. They are traditionally obtained from the technology-owner and are referred to as technical services.^{92/}

AGGREGATED SERVICES FROM THE
FOREIGN VENTURE PARTNER

The theoretical attractiveness of the joint venture is that the transferor of technology not only supplies technology, technical assistance and technical services but expertly optimises the combination: technology is fully elaborated coincident to reduced burdens of cost and risk.

This expectation, as expressed earlier, does not often materialise. First, technology tends to be transferred in its most elementary and skeletal forms, more appropriate to a finishing operation than an elaborated manufacturing facility. Second, consequent to this, the foreign partner does not have to exercise any of his expert capabilities. Third, the enterprise bears higher costs than what can be considered 'optimal'.

^{92/} While a licensee, will thus, be obtaining both 'technology' and 'technical services' from a single source, a clear distinction prevails between the two. The licensor has no proprietary rights in 'technical services' (see DIT-12, p 5).

Despite this sub-optimal combination, the profit anticipations of the partners may not be in jeopardy. This could occur for two reasons: (1) the foreign partner may have overpriced his technical inputs, and thus realised what may be called 'front-end profits' and (ii) the national partner may have mistraded current profits and profitability for long-term reliance on his partner for the supply of inputs^{93/}.

This monograph recommends to the national venture partner that while he may desire to obtain all technological inputs from the foreign partner, the technology package should be conceptually 'disaggregated' into its component elements. Disaggregation should serve three purposes: the national entrepreneur must know, as explicitly as possible: (1) what the physical plant will accomplish (as precisely as possible what the technology relates to) (2) the extent of his short and long-term dependence on his counterpart in the latter's role as 'supplier' and (3) the inputs of the foreign partner: how they are priced and in what form they will be paid for. For this purpose, both the licensing agreement and the joint-venture agreement should either be negotiated simultaneously or the

^{93/} Profits must be viewed, by the national partner, not only in relation to the quantitative level of his investment (so many thousand dollars) but also on the quality of his investment (cash and other tangible inputs).

acceptance of one made dependent on the acceptance of the other. The methodology for effecting these objectives follows.

Technology-related arrangements in the License Agreement

Typically, in joint-venture agreements, the overall technology package is dispersed into two or more agreements, importantly, the main joint-venture agreement and the technology licensing agreement.

Foreign venture partners often require this separation from the point of view of stating the capitalisation of their inputs (See Section V). In consequence, only the capitalised inputs will enter the main agreement. While all of technology and technology-related services can be capitalised, it is not international practice. Knowhow and trademark grants, for example, which are of enduring value to licensors, are not usually capitalised^{94/}.

Non-capitalised inputs of the foreign partner will find expression in the licensing agreement. In it they will be positioned to earn running royalty incomes, lumpsum fees in lieu of running royalty, etc.^{95/}

^{94/} Some times such capitalisation is thwarted by considerations as to how tax authorities in the licensor's country will treat incomes from such capitalisation.

While it is desirable, in terms of the rights of the enterprise, to secure from the foreign partner the respective written values of the disaggregated non-capitalised inputs - that is, the separate fees for knowhow, patents, trademarks, technical assistance and technical service - this may not always be feasible. A single royalty rate or a royalty fee may apply, to all of them. However, whatever is the final form of expression, the national partner should exert to obtain an informal assessment of their respective values.

Technical assistance, being a one-time service, is not a 'licensed' input. It does not have a proprietary character. If it is an input of the foreign partner, and if he does not capitalise it in the joint-venture agreement, it should normally be the subject of a third agreement^{96/} and not a part of the license agreement. A lumpsum fee would be the traditional compensation for technical assistance.

Since payments are made in the licensing agreement 'in consideration of' certain inputs, it would be to the advantage of the enterprise to have them (inputs) defined, to establish accountability of the supplier, and described, to obtain an appreciation of the detailed role of the supplier^{97/}

^{96/} The substantive content of technical assistance services is highlighted on page 7 of DIT-12.

^{97/} See DIT-12, p 12.

Technology-related arrangements in the Main Joint-Venture Agreements

As discussed earlier, definitions of technological terms are brought into the main joint-venture agreement in order to: (1) generally indicate the purposes of the joint-venture company and (2) to capitalise inputs.

The most important factor in this matter of capitalisation is for the enterprise to avoid the situation when some element of the transfer process is capitalised in the joint-venture agreement and the same element gets separately compensated (such as in the form of royalty) in the license agreement. That is, to avoid duplicated payments.

Duplicated payments cannot legally arise if all inputs have precise descriptions and their disaggregated values are known in advance. But if the joint-venture agreement is negotiated prematurely, loose terminology is used in the agreements, or costs consolidated, duplicate payments, by intention, can take place.

For instance, if 'technical services' and 'technical assistance' were capitalised by the foreign partner in the main joint-venture agreement, but a clear distinction was not drawn between them and other elements of the technology transfer process, the partner can also claim a royalty

on 'knowhow' through the licensing agreement even though supplied knowhow was nothing but technical service. In other words, by capitalising services and making them part of his equity contribution, the foreign partner first earns a division of the joint-venture's profit. Then, with technical service camouflaged as 'knowhow' a periodic royalty additionally accrues to him.

Perhaps an illustration will make this potential situation clearer. Suppose a proposed joint venture involved the making of a proprietary bottled soft drink. The foreign partner may propose to capitalise his overall cost for procuring and installing the manufacturing plant and for the training of the plant's operators (Technical Service). These may represent 30% of the foreign partner's equity investment. He may additionally propose a 5% royalty for 'knowhow'.

Since in the manufacture of proprietary drinks 'concentrates' are purchased from the foreign partner, no important transfer - such as the 'recipe' (knowhow) - takes place^{98/} mere techniques of dilution and bottling (even if through several complicated stages) are the main technological inputs to the venture. These techniques, as is obvious, are transferred by training (technical service). Hence, while a division

^{98/} It is assumed that the trademark of the softdrink is covered by an equitable trademark agreement between the partners.

of profit can rightly accrue to the foreign partner for capitalised 'technical assistance' (installation) and for 'technical services' (training) - in reward for 30% capitalisation - the 5% royalty for knowhow is clearly a duplicated and redundant claim for repeated technical service. It would be inadmissible.

Compensation for Indirect Technology-related Supplies and Services

Indirect technology-related supplies and services provided by the foreign partner can comprise any, some or a combination of the following: (1) machinery and equipment supplies (2) management services (3) specialised services (such as a site and soil survey) (4) 'pre-investment' services and (5) 'head office' (parent company office) services.

The foreign partner may wish to capitalise his supplies of machinery and equipment. If their valuation is reasonable, capitalisation is equivalent to an investment of cash. There are no special problems in its handling.

'Specialised' and 'pre-investment' services furnished by the foreign partner prior to, or concurrent with, the establishment of the joint venture are 'one-time' services. Technically, if national investment laws permit, they are capitalisable. Their valuation, however, can pose problems. Many developing countries consequently do not permit this capitalisation or will set limits to it.

Where such situations apply, the foreign partner may attempt the recovery of costs by: (a) requiring that payments be made from subsequent profits of the enterprise (b) escalation of otherwise capitalisable costs (c) raised royalties on licensed elements of technology, etc. The national partner should be alert to these possibilities in the process of negotiation^{99/}.

Payments for 'management services' (See Section IV) and 'head offices services' (payments to be made by the joint venture to the foreign partner for routine services such as export market surveys) are normally compensated under special and separate agreements. Payment for head office expenses is generally frowned upon by developing countries; but where allowable, they are usually limited to a fixed amount, to a fixed percentage of the turnover of the joint venture, or to the lower of the two costs. The capitalisation of these services would normally be resisted by developing country governments.

Treatment of Pre-investment Expenses: As indicated in earlier sections, concerning the sequence of events shown in Figure 1,

^{99/}

See DIT-12, Chapter on 'Remuneration'.

an entrepreneur seeking a joint-venture partner would first carry out some preliminary surveys and studies, and later, with the professional help of a prospective partner, re-survey initial findings and data. Such efforts would largely relate to market estimates, site studies, project feasibility reports, etc. For large projects, the partners may also have to survey international sources of equipment and meet with design firms, construction contractors, etc. These would involve expenditures for each of the partners and introduce questions of dividing expenditures.

A division of expenditure takes place even if the national partner elects to bear all of the 'out-of-pocket' expenses (travel, hotel, board, etc) incurred in the studies. This is because the foreign partner, by releasing his personnel to assist in the joint-venture project, not only temporarily loses their routine profit-related contributions to the parent firm (the so-called 'opportunity cost'), but more tangibly, has to meet 'overhead costs' (pension and social security contributions, space facilities, administrative superstructure, etc). Consequently, it would not be unusual for the foreign partner to try to debit such costs to the project, desiring either their reimbursement in cash^{100/} or capitalisation.

^{100/}

The enterprise will pay this cost from its funds after it is incorporated.

The problem that arises in this connection is the foreign-partner's possible high assessment of such costs, and thus, the prospect of their overcapitalisation in the joint-venture project.

It is generally possible to compartmentalise such expenditures (cash and non-cash costs) into two categories: (i) risk-related expenditures and (ii) elective expenditures.

For example, expense incurred in market surveys, to obtain a realistic estimate of sales, can be considered as a risk-related expenditure. The benefit of such expenditure is that it reduces the risk exposure of both the partners. The survey enables the careful tailoring of the respective investments of the partners. Such expenditures should not normally be reimbursable to the partners^{101/} or be subject to capitalisation.

On the other hand elective expenditures would be reimbursable. These are expenditures which the partners agree to as directly benefiting the security or the profitability of the enterprise. For example, such expenditure could involve

^{101/} It should be noted, again, that it is the joint-venture entity that has the liability to make the reimbursement and it is not the liability of any one partner. Secondly, tax laws in many countries permit the enterprise to recover pre-investment costs through amortisation. If a cost is capitalised it would not (generally) also be amortisable.

the selection of one of three possible manufacturing sites from the viewpoint of land topography and soil conditions. The foreign partner may carry out this survey and equitably capitalise the cost.

However, the services provided by the foreign partner are not always a one-way contribution to the enterprise. The national partner, through his influence in the national scene and knowledge of local conditions, reciprocally brings a 'market' and other advantages to the enterprise. Consequently, some of the partners' inputs can be considered as 'cancelling' each other. Hence only some of the 'elective expenditures' should qualify for reimbursement and capitalisation.

The Foreign Partner as 'licensor' of Technology:
Obligations on Technology

While it is not, again, the purpose here to discuss legal matters concerning the rights and obligations of the parties to a licensing agreement (these being adequately covered in DTT-12), some attention needs to be paid to issues in technology which are particular to an agreement involving a joint venture.

The licensing agreement with the joint venture is basically variant from that involved in direct licensing

in that the foreign partner, on the one hand, is the owner-supplier of technology, and on the other, as an owner in the joint venture, is also its recipient^{102/}. Through the power or influence the foreign partner may be able to exercise on the joint venture, it is technically feasible for him to gloss over some key issues of technology.

The standard licensing agreement covers technology, the substantive element of the technology transfer process, under the following four provisions; (i) its scope (ii) its appropriateness to the recipient country environment (iii) assurances that its technical performance (outputs, yields, efficiencies) will be consistent with the economic expectations of the project and (iv) adequacy and availability of services from the licensor so that the use of technology by the enterprise can be extended for its greater benefit.

To obtain safeguards in the transfer of technology, technology must be defined to have a broader basis than whatever is meant by the term 'manufacture' or 'technology' in the main joint-venture agreement. That is, transferred technology should meet the purposes of the enterprise as

^{102/} The joint-venture company, of course, as a legal 'person', has an identity separate from that of its owners. The licensing agreement is almost always an 'arms length' agreement. It is written irrespective of other closer relationships (such as a joint venture) between the partners.

intended at some point of its maturity. For example, transferred technology should be commensurate with the ultimate intended capacity of the enterprise and projected product range (say, sizes of washing machines) despite the situation that it might be started with a small capacity. Similarly, it must define the 'starting materials' (steel stock, chemical intermediates, etc) for which it is commensurate despite the fact that initial output will be based on assembly or formulation of imported materials (i.e. forward-integrated inputs). Likewise, the agreement should provide for continuity of licensor's essential supplies (say, a ten-year obligation to supply catalysts or gaskets) despite the possibility that the life of the technology agreement may be short (say, five years).

These provisions deepen the content of the conventional technology agreement but they constitute a rational set of requirements since the life of the joint venture will most probably be longer than the duration of the technology agreement.^{103/}

^{103/}

Since in many developing countries governments will not permit long duration technology agreements and will be selective on renewals, the joint-venture enterprise can come into the technical position of lacking technology inputs after the expiry of the technology agreements. Such a situation may not necessarily be disadvantageous to the foreign partner.

SECTION VII

JOINT VENTURE AGREEMENTS

BACKGROUND

In the introductory section of this monograph, reference was made to two types of joint ventures: (1) the joint venture which is formed by the incorporation of a company (the basic subject of this monograph) and (2) the joint venture established by the 'joint-venture agreement', in which two or more companies (or other entities) negotiate an agreement to undertake a particular type of activity, contribute a miscellany of inputs and share in the profits resulting from the activity. The discussion that follows is not related to the latter form of joint venture. Hence the 'agreements' covered here are those that will be executed only in relation to an incorporated company.

In the process of incorporating a joint-venture company several 'memoranda of understanding' and agreements will be typically executed. These can be broadly classified into: (1) those prevailing between the partners - the promoters - to the enterprise (2) those executed between the foreign partner and the enterprise (3) those executed

between the national partner and the enterprise and (4) those prevailing between the enterprise and 'third parties'.

For the enterprise to execute any of its agreements it must legally exist; that is, it must be incorporated^{104/}. On coming into existence the company can not only become a signatory to contracts but it can also affirm, if it elects to do so, undertakings which may have been made on its behalf prior to its incorporation. Consequently, arrangements that the promoters may make among themselves, as 'commitments' of the company, are conditional to this affirmation process. This affirmation sequence also applies to the bye-laws which the promoters will have drafted.

Being a 'fictitious' or 'artificial' person, the company can only act through 'natural persons' - normally, the directors. As discussed in Section III, the directors

^{104/} It might be noted that once incorporated, the enterprise or company obtains an identity separate from that of its promoters. It becomes a 'legal person', one with infinite life; its identity and permanence cannot lapse without the consenting order of a competent juridical body.

will have the authority to exercise all those discretionary powers which are invested in them by the shareholders by virtue of its byelaws. The right to negotiate and execute agreements, which would be beneficial to the company, would be a prerogative of the directors.

The most immediate actions of the company, on its incorporation, will be to affirm its byelaws and to confirm nominated directors. The latter can then initiate action to raise subscription capital. Once these basic actions are taken, it becomes possible for the directors of the company to execute agreements which will prevail between the company and one or the other of the promoters.

Since the model joint-venture company adopted in this Monograph involves promoters who will become its immediate and majority shareholders, and who will have nominated their representatives as directors in the process of incorporating the company, it may be technically possible - possible within the ambit of national legislation (e.g. Spain, India) - for the directors to legally execute agreements in the name of the company prior to both the confirmation process and the formal adoption of bye-laws.

In the general situation, however, the promoters will have to make arrangements among themselves on the

supposition^{105/} that the arrangements will later commit (be binding on) the company i.e. that the company will adopt them on its incorporation. For instance, the foreign partner, in his role as licensor, will have to assume that the company will execute the technology licensing agreement on the terms agreed to as reasonable between the partners. Likewise, the national partner will have to assume that the company will purchase the land which he offers to it and which in terms of size, quality and cost has been found acceptable to the foreign partner.

In these matters, the undertakings or commitments of the promoters, made on behalf of the company, can only be 'understandings'. These can be either oral understandings or stand expressed in a written 'memorandum of understanding' (MOU's). The latter would be normal practice in the developing country.

On the other hand, there can be other undertakings between the promoters which may be expressible in the form of a legally binding agreement between them; for instance,

^{105/} Although in the two-shareholder company the question of the 'company' not accepting the arrangements/agreements made between the parties is a moot one, there is no guarantee, however, that the directors of the company will act as directed by the shareholders.

the equity each will contribute to the enterprise, the loans they will individually make or offer to the enterprise, the affirmations of the partners to supply land and technology to the enterprise, the sharing of pre-investment costs, etc. These undertakings, of course, do not commit the enterprise and hence can be legally and effectively concluded.

While such agreements are feasible they are improbable in the legislative and regulatory environment of the developing country. With governments empowered by decrees or legislation to mediate in the allowability of certain types of equity structures, debt/equity ratios, technology fees, etc - and indeed, to approve or disapprove the manufacture of certain products - little purpose is served by the agreements. In certain countries such agreements may well be illegal if executed prior to government endorsement of its terms (e.g. India). In other countries (for instance, Mexico) an agreement may be legal if is not in conflict with relevant national laws but the enterprise it helps form may not enjoy lucrative incentives, otherwise available to it, unless it registers the agreement with a statutory authority, which before such registration, may require alteration of the terms of the agreement in the national interest. In some countries (e.g. Philippines), executed agreements involving foreign

investment must be submitted to statutory bodies, which should they find the terms unacceptable in the national interest, can cause it to become null and avoid.^{106/}

Pre-Incorporation 'Agreements'

While the above discussion is oriented to indicating the validity of certain types of arrangements between the promoters, it is obvious that many issues can be expected to arise which will have to be sorted out between the promoters before they can take their proposals to developing country governments, they can incorporate the company or commence business operations.

Normally, all of the principal concerns of the promoters will be set down in a document generally known as the 'pre-incorporation agreement'. It may be variously titled: the 'Founder's Agreement', 'Promoter's Agreement', etc. It will precede the formal instruments of joint-venture formation which alone will have full legal validity.

^{106/} Consequently, in such circumstances, whenever the promoters of a joint-venture company deem it necessary that an agreement should exist for some reason, it would be usual for them to make the effectiveness of the agreement conditional to governmental approval. Often, the rights and obligations set out between two parties to an arrangement - say, a licensing arrangement - would be 'personal' to the transacting parties, A & B. They would not be transferable to a third part C.

The provisions of the pre-incorporation agreement will ultimately be set down in three basic documents.

- A. Some of the provisions of the pre-incorporation agreement will find expression in the formal "Joint-Venture Agreement"; for example, the rights of the partners in the appointment of directors, the need for discussion and consensus prior to the raising of the company's capital, etc. Such provisions will be oriented to the long term.^{107/}

- B. Other provisions will be expressed in agreements separate to the Joint-Venture Agreement. They will generally involve special matters or arrangements of relatively short duration. For example, the licensing agreement, or the entrustment of the construction of the manufacturing plant to the foreign partner ('technical assistance' agreement),

- C. Some matters may be 'personal' to the promoters and will have informal written expression; for example, cash-flow and dividend policies of the company. Such discretion is often necessitated by the consideration that the partners cannot bind the directors of the company or abrogate their prerogatives.

^{107/} A thirty year term to a joint-venture agreement would not be unusual.

Checklist for the Pre-incorporation Agreement: The following is a short 'checklist' of matters that will be dealt with in the pre-incorporation agreements. This listing is only representative since joint-venture arrangements can be very diverse:

1. The objectives of the enterprise
 - manufacturing and trading activities
 - products to be manufactured
 - project phasing: initial and mature capacities and operations
 - market directions - domestic and export
2. The 'charter' of the company
 - public company, partnership company, etc
 - liability of members
 - participating of the members of the public - present, future
3. Project capital
 - fixed and working capital
4. Financing of the project
 - the debt/equity ratio
 - equity of the partners
 - equity and loans from the public
 - loans from partners
 - foreign currency loans, arrangements and guarantees
 - composition of debt

5. Equity structure

- capitalisation of contributed assets
- cash equity
- forms of equity capital - preference shares, deferred shares, common stock, etc.
- 'start up' and mature equity contributions

6. Control of the company

- equity distribution among the partners
- draft 'articles of association'
- rights to the appointment of directors
- 'ordinary' and 'special' resolutions; proportional representation, cumulative voting

7. Management of the company

- board form of management, sole chief executive officer, etc.
- the number of directors; at inception, maturity
- 'inside' and 'outside' directors
- chairman and managing director(s)

8. Management Policies

- working capital, profit retention and dividend policies
- capital and revenue budgets
- selection of key personnel

9. Technology, Technical assistance and Technical Services
 - source of technology
 - trade marks, patents, etc
 - costs and forms of payment
 - procurement of equipment, construction and commissioning of plant (distribution of responsibilities between the partners)
 - personnel training etc

10. Management services
 - training of executive personnel
 - loan of personnel from foreign partner
 - costs and forms of reimbursement

11. Purchase/sales arrangements
 - supplies from the foreign partner
 - sales of product: directly by the company; through a specified agent; through (other) firms of partners

12. Contingency and special arrangements
 - 'purchase of shares by one partner if disposed off by the other'
 - reassignment of agreements to other parties
 - 'fade out' arrangements, etc.

13. Schedule of activities
 - timing of equity contributions, loans, etc
 - phasing of pre-investment inputs

- execution of agreements
- operational date of project
- training sequence for personnel, etc.

THE JOINT-VENTURE AGREEMENT BETWEEN THE PARTNERS

Since governments of developing countries do usually have elective rights to approve proposed joint-venture arrangements, it is usual for the promoters to conclude a formal 'joint-venture agreement' making it subject to the consent of the government. This 'joint-venture agreement' may also be called a "Head of" agreement, 'Incorporators' agreement, etc. It is a prime document of the joint venture.

The joint-venture agreement, particularly in the context of the developing country, would be a rather straightforward agreement. Written as simply as possible, it would be aimed at strengthening the feeling of security of each partner and will provide sufficient scope - flexibility - for the partners to overcome differences of opinion when they occur.

The joint-venture agreement^{108/} deals with the rights and responsibilities of the partners and makes provision for

^{108/} See "Guidlines for the Acquisition of Foreign Technology in Developing Countries" UN ID/98(1973) for model clauses of joint-venture agreement.

the settlement of disputes. Its focus is long-range and its preamble would admit of cooperation in the long range - the expansion and diversification of the product range, enlargement of markets, etc.

Unlike associate agreements, such as the technology or management agreements, there will be no provision in the joint-venture agreement for the payment of any money from one party to the other^{109/}

THE JOINT-VENTURE AGREEMENT, IMPORTANTLY, COMMITS THE PARTNERS AND NOT THE ENTERPRISE. IT ESTABLISHES THEIR RIGHTS INTER SE AS PARTNERS.

Principal Terms of the Agreement

Only a broad outline of the joint-venture agreement can be provided here because of the different types of companies that can be formed and the fact that laws applying to the creation of joint ventures vary with the host country involved. While some of the matters already set out in the pre-incorporation checklist are repeated here, they should be seen in terms of establishing the

^{109/}Often correct legal practice requires that an agreement be based on a 'consideration'. One party may agree to pay the other a nominal 'one dollar' fee in consideration of their arrangements.

unity of the joint-venture agreement.

The normal provisions of the Joint-Venture Agreement are:

- the preamble to the agreement (the background to the agreement)
- the parties to, and the legal nature of, the joint venture
- the authorised capital of the company, its division into various types of shares; issued capital
- the equity capital of the partners and division of equity among the partners; initial equity capital
- schedule for the raising of equity funds
- constitution of the board of directors; the representation and elective rights of the partners
- appointment rights for managing director(s); other key directors
- details of the manner in which managerial rights and responsibilities of the company will be allocated (for e.g. that the Treasurer-Director appointed by the foreign partner shall have the responsibility for managing the finances and the accounts of the company)
- constitution of the management and the appointment of its members; for example, where a 'committee of the board' manages the company

- the conditions under which the equity capital of the company can be enlarged, either by the parties to the agreement or through invitation to the general public
- rights and limitations on the assignability and transfer of shares; subscription rights of non-partners; rights of 'first refusal' among the partners; options of each partner to acquire the others' shares; procedures
- the obligations of each of the partners in respect of technology, personnel, assets, etc ^{110/}
- partners' acceptance of the charter and byelaws of the company jointly drafted by them (to the extent that they will be held acceptable by the statutory authority having rights over incorporation of the company)
- the winding up and dissolution of the company; its amalgamation and consolidation; etc
- arbitration procedure in the event of dispute ^{111/}
the terms of joint-venture agreement
- etc.

^{110/} This provision, while sometimes included in the joint-venture agreement, may as well as part of other specific agreements (q.v.)

^{111/} All agreements contain provisions labelled 'boiler plate'. These are legal-administrative in nature (for example, identities of parties, governing law of agreement, etc). Such are excluded here.

Since the byelaws of the company are usually more exhaustive and legally more precise than the terms concerning 'control' in the joint-venture agreement, and are of crucial importance to the minority partner, it would not be unusual practice for the byelaws to be appended to the joint-venture agreement (made part thereof) and confirmed by the partners.

Agreements with the Enterprise

Once the enterprise is incorporated, it will be feasible for the founding directors, or for the directors formally approved by the shareholders of the company - the situation depending on the legislation in the different countries - to execute binding agreements in the name of the company, to offer guarantees, etc.

After its incorporation, the enterprise (the Directors) will typically execute agreements with the overseas partner - shareholder - for the licensing of technology, managerial services, construction of the physical facility etc. Likewise, it may conclude agreements with the national partner for purchase, or lease, of the latter's land properties, etc.

The important agreements that the enterprise may be expected to conclude with the promoter-shareholders are:^{112/}

- with the foreign partner (where applicable): the series of technology agreements (knowhow, patents, technical services, including technical assistance (construction of plant); the supply of machinery and equipment; long-term raw materials/components supply contracts; supply of managerial services; export marketing agreements (foreign partner as export sales agent); loan agreements; etc

- with the national partner (where applicable); purchase/ lease contracts for land and building; domestic marketing agreements (the partner as selling agent); loan agreements; etc.

^{112/} UN Publication DIT-12, "Guidelines for Contracting for Industrial Projects in Developing Countries (UN ID/149 (1975), "The Role of Patents in the transfer of technology to developing countries" (UN, E/3861/RW1(1964) provide necessary background material in this area.

ANNEX I

EVALUATING ROYALTY COSTS - THE PRESENT VALUE METHOD

The concept of Net Present Value (NPV) or Present Value which is routinely employed in financial analysis of projects, involving evaluation of payments and incomes, can be extended to comparing royalty rates independent of the form in which they are expressed: running royalties, lumpsum royalties and their combinations ^{113/}

The Present Value (PV) of a future receipt of money is less than its future nominal value. One hundred dollars received now (Present Value) is worth more than \$ 100 received in a year's time (Nominal Value) because it could have been used meanwhile to earn a return (interest, yield) by banking it, loaning it, or investing it in stock. That is, \$ 100 invested today at 10% interest rate or yield will be worth \$ 110 at the end of the year. Hence the Present Value (PV) of \$ 110 received a year from now is \$ 100. Similarly, \$ 242 received two years from now has a PV of \$ 200 today. Technically, the \$ 200 Present Value is said to be the 'discounted income' corresponding to a future income of (or expenditure) \$ 242 at a 10% discount

^{113/} Detailed identification of DTT-12, ID/233 and UNIDO/ICIS.51 to be provided here.

rate applied over 2 years ^{114/}

The PV of a future income (or expenditure) at a discount rate r is obtained from the 'compound interest' formula

$$PV = \frac{\text{Future Income}}{(1+r)^n}$$

where n is the numbers of years "from now" in which the future income is received.

The methodology of this technique will now be used to evaluate the PV's of the royalty expenditures indicated in Table 1.

To effectively use this PV method - or discounting technique - certain assumptions and estimates have to be made. The most important assumption is the applicable discount rate ^{115/}. In the analysis presented below - Table A - it is assumed to be 10%. An estimate of a firm's future sales is also necessary.

^{114/} A firm making royalty payments will view the making of a payment of \$ 200 today just the same as making a payment of \$ 242 after two years. Consequently, there is a Present Value to every royalty payment made at any other point of time.

^{115/} Discount Rate, while related to the interest rate, is not the interest rate. It represents the weighted cost of raising corporate finance (bonds, equity capital, long and short terms loans, debentures, etc). The US discount rate is currently about 12%.

It is assumed in Table A that the firm which is planning to establish the pumps project has provided figures of net sales^{116/}(Row 1). It is further assumed that all royalty liabilities ensue from the end of "year 1" .

Table A then illustrates, in Row 7, the present value of all payments it is called on to make should it licence any of the five technologies. Technology D is thus available at the lowest cost.

^{116/} If such a forecast was not available, then the calculations will be done on the basis that the firm sells out its full production capacity every year.

TABLE A
CALCULATION OF DISCOUNTED ROYALTIES

Unit: Million dollars

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6</u>
1. Net Sales Value at \$1000 per pump	-	3.00	7.00	9.00	10.00	10.00
2. 'Running Royalty' on sales (undiscounted)						
Technology A	-	-	-	-	-	-
B at 3%	-	0.09	0.21	0.27	0.30	0.30
C at 7.5% (a)	-	-	-	0.68	0.75	0.75
D	-	-	-	-	-	-
E at 6%	-	0.18	0.42	0.54	0.60	0.60
3. Discounting Factor at 10% Discount Rate	-	1.10	1.21	1.33	1.46	1.61
4. Discounted running Roayalties (discounted to end of year 1)						
Technology A	-	-	-	-	-	-
B	-	0.08	0.17	0.20	0.21	0.19
C	-	-	-	0.51	0.51	0.47
D	-	-	-	-	-	-
E	-	0.16	0.35	0.41	0.41	0.37
5. Flat Fees (Assumed paid at end of year 1)						
Technology A	0.90	-	-	-	-	-
B	0.15	-	-	-	-	-
C	-	-	-	-	-	-
D	0.20	-	-	0.20	-	0.20
E	0.001	-	-	-	-	-
6. Discounted fee for Technology D	0.20	-	-	0.17	-	0.14
7. Summated Present Values: Sum of PV's of Rows (4) and (5) (b)						
Technology A	.....	.....	.....	.....	.....	.....
B	.....	.....	.....	.....	.....	.....
C	.....	.....	.....	.....	.....	.....
D (b)	.....	.....	.....	.....	.....	.....
E	.....	.....	.....	.....	.....	.....

(a) Royalty in last three years' per the terms of Technology Supplier C

(b) For Technology D, only figures of Row 6 apply.

ANNEX II

EXCERPTS FROM VARIOUS NATIONAL INVESTMENT LAWS

Mexico

Law to Promote Mexican Investment and to Regulate Foreign Investment (English Translation provided by the Government of Mexico).

1. Definition of 'foreign investment' (Article 2)

Foreign investment considered undertaken by foreign corporate bodies; foreign physical persons; foreign economic entities; Mexican enterprises with majority foreign capital and business enterprises where foreigners determine the management of the enterprise. Law extends also to foreign capital involved in acquisition of properties.

2. Reserved Industries

a) Industries reserved exclusively to the Government

Petroleum and other hydrocarbons; basic petrochemicals; radio active minerals; generation of nuclear power; electricity; rail roads; other activities established in specific laws (Article 4).

b) Industries reserved for Mexicans or Mexican Companies (with exclusion-of-foreigners clause):

Radio and TV; urban and inter-urban transportation; domestic air and marine transportation; forestry resources; gas distribution; and others established in specific laws (Article 4).

c) Favoured investments (Article 13)

projects that are: complementary to national investment; that do not displace national enterprises; that have positive effect on balance of payments; that increase exports; contribute to less economically developed regions (Article 14).

3. Limits on foreign investment (Article 5)

a) 49% of maximum foreign capital in the case of exploitation and use of substances subject to ordinary concessions; and to 34% in the case of exploitation of national mining reserves

b) 40% of maximum foreign capital in secondary petrochemicals

c) where specific legal provisions do not specify a particular percentage, foreign ownership can not be more than 49% (provided the foreign firm is not empowered to determine the management of the national enterprise).

d) Conditionality clauses

The National Commission in establishing percentage of foreign and domestic ownership will examine projects relating to their effect on employment creation and wages; technical and management skill transfers to Mexicans; the incorporation of domestic inputs; external financing; geographical dispersion; concentration of monopoly powers in domestic markets; contribution of technology to national R&D; contribution of project to national development policy objectives; etc.

4. Implementing and Regulatory Authorities

National Commission on Foreign Investment (Article 11) will be the regulatory body, giving effect to the law, assisted by an Executive Secretary appointed by the President of the Republic (Articles 11-13).

Decisions adopted by the Commission will be implemented by the Executive Secretary (Article 14) and the decisions of the commission will be made known to State Secretaries and Departments, which will issue proper authorisation (Article 15). State Secretaries and Departments, in their areas of competence, will decide specific cases according to criteria set by the Commission (Article 16).

5. Management of Enterprises

The participation of foreign investment in the administration of the business enterprise may not exceed its participation in the capital.

6. Acquisition and Control of Established Enterprises

Authorisation by the Secretary of the economic Ministry is required when foreign corporate bodies, foreign physical persons, and others covered under Article 2, acquire more than 25% of capital, acquire over 49% of fixed assets of a business enterprise or acquire management control of a business enterprise (Chapter II Article 8). The National Commission on Foreign Investment may, where it deems convenient, grant preferential option to Mexican investors in regard to acquisition (Chapter II, Article 10).

INDIA

The Foreign Exchange Regulation Act (FERA), 1973 and the Industries (Development and Regulation) Act (IDR) 1951

1. Definition of Foreign Investment, Foreign Currency, etc. and of Foreign Investors, etc.

Neither FERA nor IDR define 'foreign investment'. 'Currency' (includes all coins, currency notes, bank notes, cheques, drafts, traveller's cheques, bills of exchange, etc), 'foreign currency' (any currency other than Indian



currency), 'foreign exchange' (all deposits, credits and balances payable in foreign currency, drafts, letters of credit, etc), 'Indian currency' (expressed or drawn in Indian rupees, etc) and 'foreign security' (security created or issued elsewhere than in India and security the principal or interest of which is payable in foreign currency, etc) are tautly defined. (FERA, Article 2).

Important to the definitions of foreign investor are those of "person resident in India" ("a citizen of India" but does not include a citizen who has gone out of, or stays outside India for taking of employment, business etc; and "a person, not being a citizen of India, who has come to India for employment, business, etc) and "person resident outside India" (a person not resident in India).

2. Reserved Industries

Schedule A of IDR lists industries which are wholly reserved for the Public Sector (atomic energy; iron and steel; coal and lignite; mineral oils; air transport; ship building; generation of electricity, etc) and those in which, while open to both public and private sectors, will increasingly be dominated by the public sector (aluminium; machine tools; antibiotics and other essential drugs; fertilisers; road transport; etc).

In addition, under the licensing policy statements of 1970, 1971, 1977 and 1980 (under authority of IDR) the Government has reserved several hundred industrial and consumer products for future exclusive production by the small scale sector, defined in terms of fixed investment and/or labour employed, (biscuits, ice cream, knitted cotton cloth, woollen gloves, woollen furniture, waxed paper, letter pads, leather shoes, canvas hoses, PVC footwear, HDPE monofilament, etc).

Still again, the Government, through Press Notes (Under authority of IDR) lists industries, which are (i) open to foreign investment (to non-resident interest) (ii) open to the application of foreign technology but not to foreign investment and (iii) those which, without special merit, will not qualify for foreign technology or investment. ('banned list').

3. Limits on Non-Resident (i.e. Foreign) Investment

Under Rules framed under IDR, no person or firm can undertake manufacture (enter into an "industrial undertaking") of any product, or for a non-resident to undertake any business activity, without the approval of authorised governmental bodies. Further, all manufacturing activity needs to be registered with Governments, in the process of which the authorities may impose conditionalities.

Under FERA Policies, equity participation without the transfer of technology will generally not be permitted (recently relaxed for investments from OPEC countries). The degree of acceptable non-resident investment, solely authorised by the Reserve Bank of India (RBI), will be governed by (a) priority of the industry (b) sophistication of technology (c) promotion of exports (d) need for improvement of product quality, etc. Normally, RBI will restrict non-resident investment to 40% of equity capital. Higher equity to 74% may be allowed in cases of high priority industries or those highly export-oriented. For industries oriented to 100% export, foreign equity up to 100% may be allowed.

Conditionalities

Both in respect of the allowance of and the registration of an industrial undertaking, either or both the Foreign Investment Board and the Reserve Bank of India can impose conditionalities on the 'industrial license'.

In allowing registration, the Foreign Investment Board may or may not permit plant locations in certain geographical areas and territories; may set maximum permissible operating capacity (production); may limit import rights to raw materials, components, machinery, etc; may set export requirement; grant or not grant royalties lumpsum payments, etc for patents, knowhow, trademarks, etc.

Under FERA, however, the law places certain conditions on non-resident investments when they exceed 40%. Typical of these are places at which business can be carried out in India; the acquisition of the whole or part of other industrial undertakings; to appointing of sole selling agents; acceptance of non-resident investment; guarantee of any debt or liability; act as technical or management agent; employ foreign citizens; acquisition of immovable property; etc. (The undertaking of any of these activities, thus, requires general or specific permission from the Reserve Bank of India).

4. Implementing and Regulatory Authorities

Except for certain special rights of the Central Government (for example, the right to approve residents associating themselves with concerns outside India, Article 27 of FERA), or certain rights shared by the Central Government and the Reserve Bank of India (for example, a resident guaranteeing a non-resident in respect of any debt or obligation - Article 26(6) of FERA), the Reserve Bank is the primary implementing authority for FERA regulations.

An apex inter-ministerial Committee of Government Secretaries, called the Project Approval Board, is the

instrument of the Central Government that supervises the decision powers granted to various component committees that authorise and regulate industrial undertakings, including those involving foreign investment, in conformance to the IDR Act.

5. The Management of Enterprises

FERA, IDR and the Companies Act, 1955 have different rights in approving or regulating the management boards of Indian Companies, including those with non-resident investment. The Companies Act (which does not differentiate between Indian and foreign companies) requires that a company be managed by a board of directors (with a minimum of two directors) and 'public limited' companies are required to obtain the approval of the enforcement agency, Board of Company Law Administration (created under the Companies Act) of the elected directors, the Managing Director etc. The Act also gives powers to the Board to appoint directors in a company if mismanagement is suspected. The Reserve Bank of India, under FERA, has the power (Article 30) to approve, or not approve, the employment of foreign nationals in Indian enterprises; in companies with more than 40% non-resident investment, to approve the nomination of persons or companies as agents or technical or management advisers in India (Article 20), etc. Under IDR, the Central Government has also the authority to take over the management of industrial

undertakings for certain periods in certain circumstances (Article 18A), etc.

6. Acquisition and Control of Enterprises

For example, in the case of large-scale industrial undertakings (with assets singly, or together with interconnected undertakings, exceeding Rs 200 million), or "dominant undertakings" - so-called 'monopoly houses' - (with assets singly or together with interconnected undertakings exceeding Rs 10 million), section 108A of the Companies Act requires the Central Government to approve the acquisition of equity shares of another company should such exceed 25% of its paid-up equity, or (under 108B) to the transfer of 10% or more of its subscribed equity capital to another company (and which is likely to change the composition of the company Board of Directors prejudicial to public interest). Again, as example, under the IDR Act the Central Government has the authority (Article 18AA) to take over industrial undertakings under certain prescribed circumstances, and to re-start industrial undertakings, in public interest, should a company be in the process of undergoing liquidation (Article 18FA).

Similarly, the FERA Act also controls the disposal or transfer of securities. For example, without the permission of the Reserve Bank, no person can transfer any security or create interest in any security in favour of a person

resident outside India (Article 9) or no person resident outside India can transfer any interest to any person also resident outside India. (Article 26).

CHINA

The Law of the People's Republic of China, on Joint Ventures using Chinese and Foreign Investment. (July 1979). ('Unofficial translation' provided by the Chinese Government). The Law is abbreviated here as 'JV Law'.

1. Definition of Foreign Investment

Each party to a joint-venture (the basic form of foreign investment permissible in PRC) can invest cash, capital goods, industrial property rights as investment (Article 4) but technology or equipment contributed shall be 'truly' advanced and appropriate to China's needs, and their valuation must be acceptable to both parties. The various contributions of the partners are required to be specified in the Articles (Article 4). The foreign investor can be foreign companies, enterprises, other economic entities and individuals.

2. Reserved Industries

The JV Law does not provide any listings of industries banned, reserved or open to the foreign investor.

3. Limits to Foreign Investment

The Law (Article 4) only provides that foreign investment participation shall, "in general" not be less than 25% in the capital of the Joint Venture.

Conditionalities: All activities of the joint venture shall be governed by the laws and decrees of the Government of China (Article 2). The joint venture is required to take the form of a limited liability company (Article 4). The joint venture is required to conduct its foreign exchange transactions in accordance with the Foreign Exchange Regulations of PRC. While the joint venture can obtain funds, for business operations, directly from foreign banks, (Article 8), remittances of profits and fees - in currencies specified in contracts - is possible only through the Bank of China (Article 10). Distributable profit is after 'joint venture income tax' and after the deductions creation of reserve funds, etc as required under the articles of incorporation (Article 7).

4. Implementing and Regulatory Authorities

Authorisation for contracts and agreements under the joint venture lies with the Foreign Investment Commission (Article 3) and are required to be registered with the General Administration for Industry and Commerce (Article 3).

The China International Trust and Investment Corporation (CITIC) has been created under a statute to introduce, absorb and apply foreign investment, and to undertake, in its own rights joint venture activities, in pursuance of socialist modernisation of PRC. The corporation, 'under commission' of foreign enterprises, etc will undertake to negotiate and enter into contracts with Chinese economic entities or introduce the latter to foreign counterparts.

5. The Management of Enterprises

JV Law (Article 6) requires joint ventures to be managed by a board of directors with the composition stipulated under the articles of association of the joint venture firm. The board of directors is required to have a Chairman appointed by the Chinese participant with "one or two" vice Chairmen appointed by the foreign participant. The executive personnel of the joint venture are required to be drawn from the various parties to the joint venture. The production and business programmes of the joint venture are to be filed with "authorities concerned" (Article 9) and implemented through business contracts.

6. Acquisition and Control of Enterprises

The Chinese Government protects "by the legislation in force" (Article 2) the resources invested by the foreign

participant and the profits due to him pursuant to agreements. The transfer of one party's share in the registered capital can be effected only with the consent of the other parties to the venture (Article 4).

Wherever necessary a joint venture may set up affiliated agencies outside China. The contract period of a joint venture may be agreed upon between the parties. However, extension of period is subject to authorisation by the Foreign Investment Commission(Article 12).

EGYPT (UAR)

Law No.43 of 1974: THE INVESTMENT OF ARAB AND FOREIGN FUNDS AND FREE ZONES (English translation provided by Government) AMENDED BY LAW NO.32 of 1977.

1. Definition of Foreign Investment

Law 43 defines "invested capital": free foreign currency transferred to UAR through an approved bank; machines, equipment, imported raw materials necessary for the project; intangible assets such as patents and trademarks registered with International Conventions; free foreign exchange spent on "preliminary studies", etc, profits realised by "project", "approved" retained profits; free foreign exchange transferred to UAR through an approved bank and used to subscribe to the Egyptian stock; free foreign exchange transferred through an approved bank and utilised for purchase of land; etc.

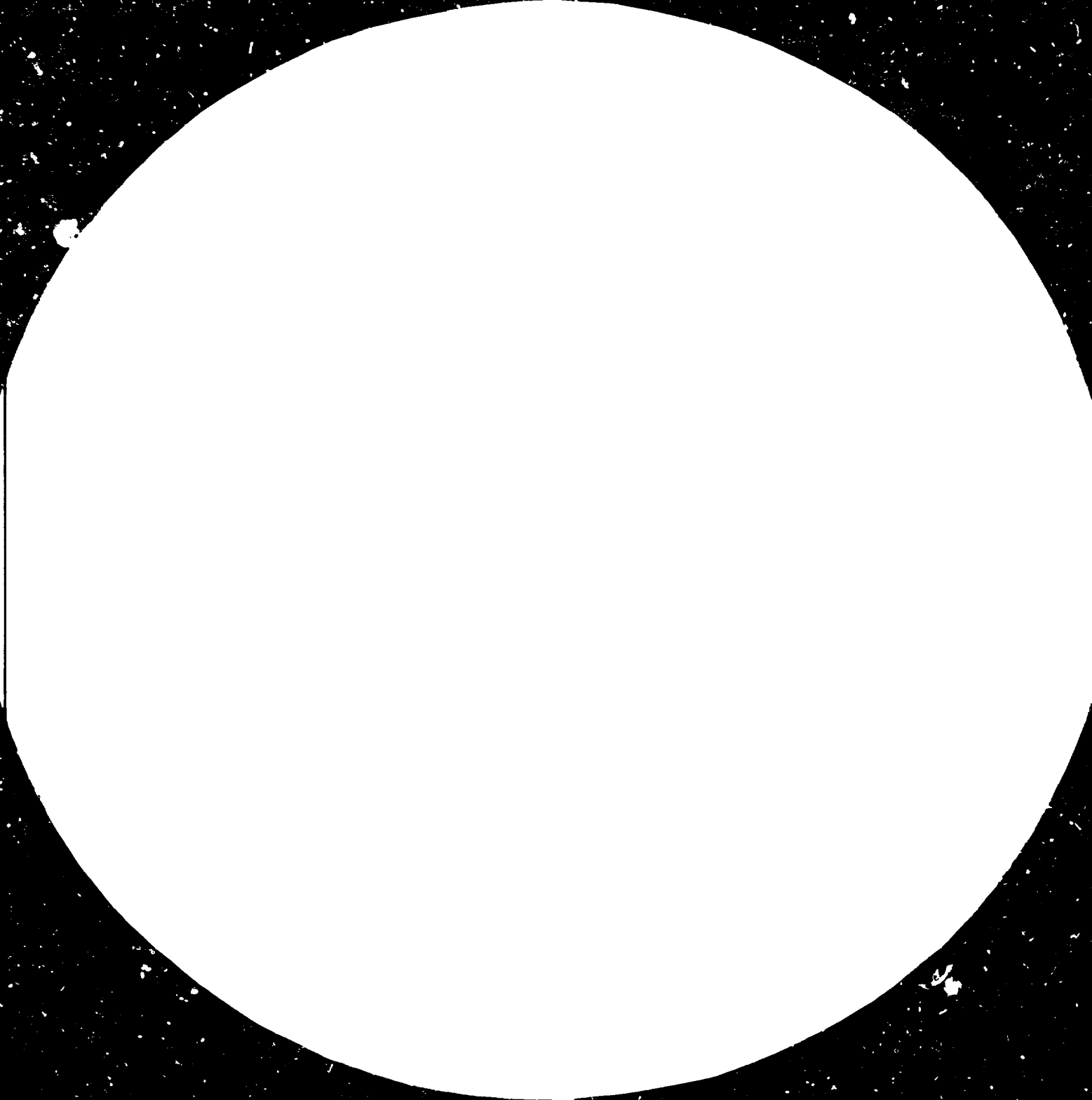
Privileges accorded to foreign capital is tied to their being associated with "Projects" as defined under the Law (See Section 2).

Companies enjoying the provisions of the Law will be deemed to belong to the private sector of the economy irrespective of the legal nature of the indigenous capital participating therein. (Article 9). Thus, legislation regulations and statutes applicable to public sector enterprises will not apply to such joint venture companies.

2. Reserved Industries

"Project" is any activity included in the Law or approved by the General Authority for Investment and Free Zones in accordance with the Law (Article 1). Projects will include investments in "industrialisation", mining, energy, tourism, etc; reclamation of barren land, etc; investment companies which aim at utilising funds enumerated in the law; technical consultant activities in Project fields, in the form of joint-stock companies in partnership with international companies; etc (Article 3).

The Law, however, does make a difference between Arab and non-Arab foreign capital, permitting Arab capital investment in housing projects (which otherwise may not be undertaken by foreign capital even in participation with Egyptian capital). "Arab invested capital", is also defined (Article 4).





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Resolution Test Chart

3. Limits on Foreign Investment

Unless the Board of Directors of the General Authority for Investment and Free Zones (GAFI) approves by a majority of two-thirds vote of its members, (Article 4) and thus grants exemption, all project investments will be made together with public or private Egyptian capital. No upper and lower limits are set in the law in relation to joint ventures for 'project' industries.

Foreign experts and employees brought from abroad to work in the 'projects' shall be permitted to remit up to 50% of their gross earnings by way of wages and compensation (Article 20).

Re-exportation or disposal of invested capital, after obtaining approval from GAFI, is permissible provided five years have elapsed from the date of capital import as fixed in the registration certificate; the transfer abroad is permissible in 5 equal annual instalment. Invested capital brought in by kind, can be exported in kind. (Article 21).

Shares offered in free foreign currency can in all cases be sold at the Egyptian stock Exchange and sales proceeds transferred to seller's account abroad (Article 21), etc. Shares, including founders' shares, cannot be transferred during the first two years of the project unless approved by the Board of GAFI.

4. Implementing and Regulatory Authority

The Board of Directors of the General Authority for Investment and Free Zones, under the Chairmanship of the Minister of Economy and Economic Cooperation, is the prevailing authority in all matters of the authority.

5. The Management of Enterprises.

Law 43 calls for joint ventures to be established as joint stock companies managed by a board of directors whose maximum and minimum number is set by the founders (in the Articles) and approved by the Authority. The Law requires that representation on the board of the Company should reflect shareholder interest. The board is required to elect a Chairman and name him in the Articles. The board is entitled to elect, from among its members, one or more managing directors. The term of the directors is fixed by the Law. The board is required to assume 'broadest powers' to manage the company. The board is vested with the right to delegate a part of its management work to a Committee of the board. Articles are required to incorporate provisions for the formation of an "Assistant Administrative Committee" to be constituted from among the employees and

workers to represent Egyptian and foreign employees.

6. Acquisition and Control of Enterprises

A company can be merged with similar organisations, or may buy out, or affiliate with, other organisations with the approval of the General Authority, GAFI (Article 3 of Model Statutes for Joint Ventures). A joint venture company is required to be organised for a specific period of time and cannot extend its life without the approval of the authority and ratification by a Decree of the President of the Republic. Shares cannot be disposed of for foreign convertible currency without the approval of the General Authority (Article 9 of Model Articles).

Invested capital registered with the Authority can be disposed of for free foreign currency after "informing" the authority (article 21 of Law 43).

(Provisions relating to investment in Free Zones are excluded in the above coverage).

