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HM Treasury Guidance
prepared by Partnerships UK

A Guidance Note for Public Sector Bodies forming Joint Venture Companies with the Private Sector

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This guidance outlines the important issues for public sector bodies forming joint venture companies. The document concentrates on the issues associated with the creation of joint venture companies by the public sector in partnership with the private sector for the purposes of creating value under the Government's Initiative "Selling Government Services to Wider Markets" (the Wider Markets Initiative).

Further information about this guidance and other queries about the Wider Markets Initiative should be addressed to the Partnerships UK Wider Markets helpdesk (020 7273 8340, wider_markets@partnershipsuk.org.uk)

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LIST OF ABBREVIATIONS

DEL	Departmental Expenditure Limit
DTI	Department of Trade and Industry
EC	European Community
ECMR	EC Merger Regulation
HMSO	Her Majesty's Stationary Office
HMT	Her Majesty's Treasury
IP	Intellectual Property
IPR	Intellectual Property Rights
MRC	Medical Research Council
NAO	National Audit Office
NDPB	Non-Departmental Public Bodies
OGC	Office of Government Commerce
OFT	Office of Fair Trading
OJEC	Offical Journal of the European Communities
ONS	Office of National Statistics
PLC	Public Limited Company
PPP	Public Private Partnership
PSRE	Public Sector Research Establishment
PUK	Partnerships UK
R&D	Research and Development
SFPC	Self-Financing Public Corporation
TUPE	Transfer of Undertaking (Protection of Employment) Regulations

1. INTRODUCTION

This guidance outlines the important issues for public sector bodies forming joint venture companies. The document concentrates on the issues associated with the creation of joint venture companies by the public sector in partnership with the private sector for the purposes of creating value under the Government's initiative *Selling Government Services to Wider Markets* (the Wider Markets Initiative).

This section sets out:

- The purpose and scope of the guidance.
- What is meant by a joint venture.
- Why choose a joint venture company.
- How the public sector should determine its equity stake and extent of control of the joint venture company.
- Key steps in forming a joint venture company.

1.1 Purpose

1.1.1 The purpose of this guidance is to consider the issues that a public sector body intending to form a joint venture company with the private sector will need to address. It does not provide advice on whether a joint venture company will be the best route in a given circumstance. Before proceeding with forming a joint venture company, a public sector body must have conducted a thorough analysis, including policy, value for money and commercial considerations and appraisal of alternative options, in order to justify this decision.

1.1.2 The term 'public sector body' is used to refer to central government departments, agencies and NDPBs to whom the Wider Markets Initiative[1] applies. It also refers to most public corporations, including NHS Trusts and other NHS bodies, agencies, NDPBs and Trading Funds but not to 'self-financing public corporations'[2] (other than to any which are Trading Funds) or to local authorities.

1.1.3 Many of the issues raised in this guidance are nevertheless applicable more widely. Public sector bodies not specifically covered here can seek advice from their relevant organisation; for example, issues surrounding statutory powers and classification of local authority joint venture companies should be raised with 4Ps.[3]

1.1.4 Similarly, although this guidance is aimed at those forming joint venture companies to generate commercial revenues from the exploitation of assets under the Wider Markets Initiative, much of it will apply to joint venture companies being formed for other purposes. There will, however, be some differences of emphasis, for example greater public sector controls and accountability would typically be appropriate for joint venture companies set up to deliver core government services.

[1] *Selling Government Services into Wider Markets: Policy and Guidance Note,* HM Treasury , July 1998. Available at the HM Treasury website: http://www.hm-treasury.gov.uk/mediastore/otherfiles/sgswm.pdf.

[2] Where so defined in agreement with the Treasury General Expenditure Statistics Team.

[3] The Public Private Partnership Programme, http://www.4ps.co.uk/the4ps/.

1.1.5 Forming a new joint venture company will involve complex negotiations in a number of areas, and will require resources in terms of management time and to cover advisory fees. There will also be great variation between objectives, form, and asset types, which will influence the nature of the joint venture company. Given the variety, this guidance does not attempt to describe one 'best' way to form a joint venture company. Rather, it sets out the relevant considerations that public sector bodies should be aware of. It is also imperative that a public sector body has carried out an appropriate appraisal and feasibility study to consider other potential options (service/supply contracts, licensing etc.) in order to justify pursuing the joint venture company model. For example, the objectives might be more effectively achieved through a straightforward contractual arrangement. This document does not attempt to cover the relative advantages of these other options.

1.2 Background

1.2.1 The guidance is being issued in the context of a number of Government policy initiatives relating to Public Private Partnerships (PPPs) between the public and private sectors. These initiatives include the Wider Markets Initiative, outlined in *Selling Government Services to Wider Markets: Policy and Guidance Note,*[4] which encourages the greater exploitation of irreducible spare capacity in public assets and goods derived from them, and the *Government's Response to the Baker Report*[5] which encourages the exploitation of the outputs of publicly funded research.

1.2.2 The Wider Markets Initiative introduced a number of policy revisions, including the automatic right to retain the benefit of receipts generated by sales into wider markets. The Initiative encourages the commercial exploitation of both physical assets (spare capacity of equipment, land, buildings etc) and intangible assets (software, databases, skills, intellectual property etc.).

1.3 Scope

1.3.1 The term "joint venture" can describe a range of different commercial arrangements between two or more separate entities. This guidance relates to just one type of joint venture structure: a company incorporated in England and Wales under English law,[6] limited by shares.

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[4] *Selling Government Services into Wider Markets: Policy and Guidance Note,* HM Treasury, July 1998.

[5] *The Government Response to the Baker Report,* Office of Science and Technology and HM Treasury, 1999. Available from HM Treasury website at http://www.hm-treasury.gov.uk/documents/enterprise_and_productivity/research_and_enterprise/ent_sme_baker.cfm

[6] Many of the principles discussed here will also apply to joint venture companies established under Scottish or Northern Irish law, subject to detailed considerations of the law in those countries.

1.3.2 In commercial accounting terms, "joint venture" has a specific meaning whereby policy decisions require the consent of each party.[7] This definition is *not* used for the purposes of this document. Here, the definition of a joint venture covers companies controlled by either the public sector or the private sector, or where there is no overall control (deadlock joint venture).

1.3.3 In addition, this guidance assumes for simplicity that the limited company will have two shareholders: one public sector and one private sector shareholder, though much of the material is relevant if there are two or more private sector partners. The guidance does not specifically consider situations where more than one public sector body is involved in a joint venture.

1.3.4 For the purposes of this document reference to "NewCo" or "joint venture company" will mean, unless specified otherwise, a limited liability company as defined in this section.

1.3.5 This document supplements joint venture guidance currently available in the public domain (such as HM Treasury's guidance on Trading Funds[8] and publications on joint ventures produced by law firms and others), concentrating on issues of relevance to public sector bodies. It does not negate the need for appropriate professional legal and financial advice when setting up a joint venture company.

1.4 What is a joint venture company?

1.4.1 A joint venture company with public and private sector shareholders is a distinct form of Public Private Partnership (PPP). For the purposes of this guidance a joint venture company assumes the creation of a new company, which will be a separate legal entity with its own name, say NewCo Limited ("NewCo"). NewCo will be the vehicle by which the common enterprise of the joint venture is carried out. It is important to distinguish the formation of a joint venture company from purely contractual arrangements, such as for the provision of goods or services.

1.4.2 The setting up of a joint venture company requires legal documents to be agreed between the founders – the Memorandum and Articles of Association, and usually a Shareholders Agreement (see Section 4.7). These documents will define: the way NewCo is to be run and disputes resolved; exit strategies (see Section 4.12); how often directors and shareholders meet; and the nature of the business and constraints.[9] The activities of NewCo will usually be governed by a business plan, which will lay out the future direction and activities for NewCo. The business plan will be updated on a regular basis and agreed by NewCo's directors; it could, if desired, be subject to approval by the shareholders.

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[7] Financial Reporting Standard 9, paragraph 4 (available via the website of the Accounting Standards Board, http://www.asb.org.uk/publications/index.html)

[8] *Guide to the establishment and operation of Trading Funds* HM Treasury Central Accountancy Team, January 2001. Available from the HM Treasury website: http:// www.hm-treasury.gov.uk/documents/public_spending_and_services/guidance_for_government_departments/pss_ggd_operation.cfm

[9] Some of the requirements of Company Law, such as the need for a Memorandum and Articles of Association, are being reviewed by the DTI and may be changed in a subsequent Companies Act.

1.4.3 The shares of NewCo will be owned by the public sector body and a private sector partner (NewCo's "founding partners", who will become NewCo's "shareholders" when it is established). The shares may be held in any proportion, such as 50:50, 75:25 etc. NewCo will have a board of directors, usually consisting of representatives of the shareholders (or appointed by them) in the rough proportion to the size of shareholding, who will have legal responsibility for managing NewCo. The board and/or the executive management will make most of the decisions on the running of NewCo. Some matters will be identified as being reserved for decision by the voting of the shareholders themselves.

1.4.4 Where the joint venture partners provide skills and assets to NewCo, this should be done under separate contracts. For example, one or both partners may license existing intellectual property rights to NewCo (see Section 5.2). The terms of these contracts (referred to in this guidance as "subsidiary contracts") will impact upon the liabilities of the partners and the value of NewCo.

Box 1: BBC Worldwide and television channel joint ventures

A core element of the BBC's strategy is to supplement its licence fee revenues by commercial exploitation of its assets: programme-making and technological skills, brand and archive. However, the BBC's ability to build commercial cash flow and long term value is constrained by a number of important factors, including:

- its very tight borrowing limit;
- its relative inexperience in marketing;
- strong competition from much larger international organisations; and
- the need to protect licence fee payers from risk.

BBC Worldwide is the BBC's main commercial subsidiary. It has set up a range of joint ventures in television and publishing. Two examples stand out: UKTV and a joint venture with Discovery. In both partnerships the BBC obtains access to risk free investment funding, equity stakes in ongoing commercial ventures and cash flows from the supply of programming to the television channels.

In April 1997 BBC Worldwide and Flextech plc (now owned by Telewest) established the UKTV joint venture. The joint venture provides pay-TV channels designed for the UK satellite, cable and digital markets. The BBC creates and retains editorial control of the channel programming. Telewest funds the development of the channels and is responsible for providing distribution, airtime sales, off-air marketing and management services.

The joint venture company between the BBC and Discovery, cemented in March 1998, aims to build and fully capitalise on the BBC factual brand globally bringing maximum commercial value and exposure to the BBC. The deal was originally worth about £350m which was split in to three parts:

- Programme production – Discovery agreed to invest £175m over 5 years in factual programmes with the BBC.
- Global channels – Discovery and the BBC agreed to launch Animal Planet and People and Arts channels as jointly owned networks all over the world.
- BBC America – Discovery launched a wholly owned BBC channel for American audiences. Discovery market and distribute the channel and handle advertising.

The BBC has contributed programme making skills, scheduling skills and a rich programme archive. Discovery contributed factual channel operations, marketing, distribution skills and investment funding.

Source: BBC, Partnerships UK

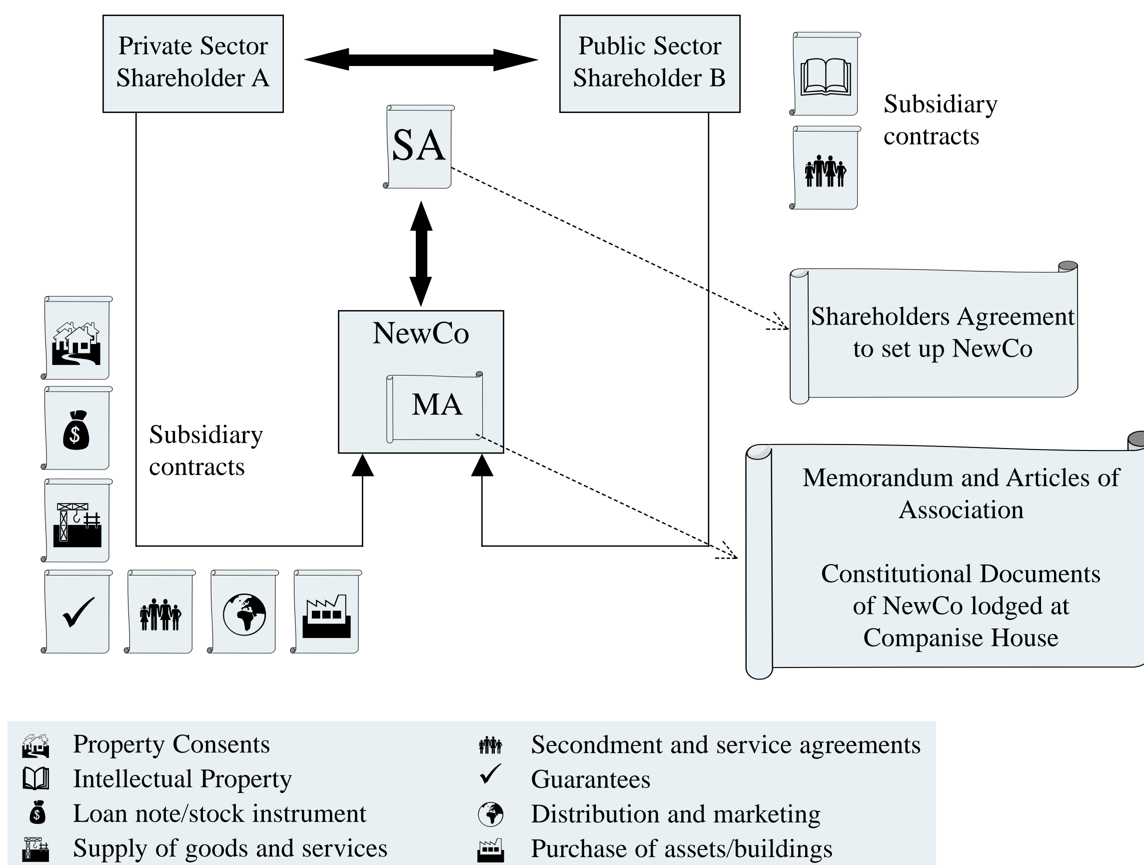


Figure 1: An example of a public-private joint venture company
In this example the public sector partner provides access to intellectual property and some staff and services, and the private sector partner provides complementary skills and financial resources.

1.5 Why choose a joint venture company?

1.5.1 Joint ventures companies are usually established because the parties have complementary objectives: each has a contribution to make to the delivery of a successful business or venture, which they would be unable to achieve independently at lower cost or risk. Generally joint venture companies are appropriate when a business is being created that needs investment and flexibility to maximise its potential. There will, however, be many occasions when the desired results can be achieved more easily through a contractual relationship. Some of the key features of joint venture companies are set out below; whilst these may encourage public sector bodies to consider them as a model, they also highlight some issues that need careful thought.

1.5.2 Key features of a joint venture company from the public sector point of view include the following:

- It will have its own legal capacity, separate from its founders. Consequently, NewCo can own and deal in assets, employ people, enter into contracts in its own right, and if it is classified to the private sector (see Section 2.4) will be subject to private sector accounting and tax considerations. It will succeed or fail by its own efforts. These features need to be balanced against issues such as directors' liabilities, insolvency legislation and wider implications for the public sector body such as public accountability, ministerial responsibilities and audit requirements.

- Using a company structure can improve access to the skills and other resources of the private sector partner(s), such as finance and manufacturing technology.
- The company structure provides a mechanism for capturing longer term value, as the public sector will hold an equity stake in the company.
- Joint venture companies provide flexibility. For example, they can be set up so that they will not pay any dividends in the early years, and any capital growth in terms of share price will only be realised by selling some or all of the shares. Alternatively, other mechanisms with differing value/risk profiles may be employed, such as licensing the public sector assets to NewCo in return for a defined sum, or taking a royalty on any sales.
- Staff can be given a greater incentive to succeed, through the prospects of higher salaries and rewards such as bonuses or share options.
- A skilled independent management team can be put in place in the new company.
- A company structure encourages greater focus on the business plan and achieving goals. NewCo, as a single entity, can also help in branding/marketing a product or service and dealing with customer enquiries.
- A joint venture company can allow better management of risks and can be used to limit liabilities to the public sector.
- Where necessary, it is still possible for public policy objectives to be preserved by securing the desired level of control in the decision making of NewCo as a shareholder or on the board, or by including provisions in the governing legal documents.

1.5.3 There are a number of issues that need careful consideration in order to ensure that the potential benefits of a joint venture company are properly captured. For example, joint venture companies can be difficult (and unsuccessful) when the partners have profound differences in culture, or different underlying commercial objectives.[10] The public sector body will also need to manage its exposure to risk. After time, the new entity can alter its strategic direction from that originally desired by the founders, if effective joint control mechanisms are not put in place. Also, creating a joint venture company could create conflicts of interest between public sector staff acting in the role of company directors and their roles as public employees.

1.5.4 There will be many occasions when a joint venture company is not the best option and the desired results can be more easily or better achieved by other means. Any consideration of the merits of a joint venture company must include an assessment of the benefits and disadvantages of other options. Although not in the scope of this guidance, a number of different sorts of contract could be an alternative to establishing a joint venture company, including:

- service/ supply contracts;
- licensing agreements;
- distribution agreements (including royalties); and
- research and development/ co-operation contracts.

[10] The advantages of clear objectives and a recognition of the importance of aspects such as the alignment of business interests, trust-based relationships and effective collaboration were identified by the National Audit Office in *The Radiocommunications Agency's Joint Venture with CMG: Report by Comptroller and Auditor General HC 21 Session 2000-2001:8 December 2000.*

Box 2: British Waterways telecommunications joint venture

In the early 1990s British Waterways (BW) decided to search for a partner to help exploit the potential to use the UK's canal network as a telecommunications network (paralleling the use of railways and electricity grid networks for similar purposes). The rationale behind the idea was that high-capacity optical fibre cable could be laid alongside the canal network, reducing the environmental impact of building the overall network and providing the ability to lay cable very quickly and inexpensively, while providing a more secure environment for operators' cables.

Initially BW held a "beauty contest" with various telecoms operators, and chose Marconi as its partner. The two partners formed a contractual venture called Fibreway. Fibreway investigated demand for new telecoms cables in areas where BW owns canals, and decided to lay a cable between Glasgow and Edinburgh. Marconi paid BW an initial wayleave payment for the use of this canal.

In the mid 1990s Fibreway expanded its network and now uses 650km of BW navigations. BW decided that it wanted to increase its chances of long-term return from the venture, and after various renegotiations it took a minority shareholding (10%) in Fibreway when it was separated off from Marconi in 1998. Fibreway was rebranded ipsaris in 2000 to reflect its change in business from dark fibre provider to telecoms managed service or bandwidth provider to corporate customers. Subsequently in early 2001 Railtrack also became a minority shareholder, with Marconi retaining their major shareholding.

The ipsaris network expanded substantially in 1999 and 2000 and now extends to over 3000km in the UK and in four countries in Europe. A rights issue in 2001 diluted BW's stake in ipsaris to 3.2%, but BW continues to receive a significant (over £6m in 2000-2001) income from ipsaris annually. All of this income is reinvested back into the canal network.

In July 2001 ipsaris merged with Easynet. This brings together ipsaris' extensive fibre network and Easynet's large existing customer base in the UK and Europe.

Source: Partnerships UK, British Waterways

1.6 Determining the public sector interest in the joint venture company

1.6.1 A key issue for the public sector will be to determine the nature and extent of its interest in NewCo and hence the level and type of controls it will need over NewCo's activities. Current and future public service requirements of assets which will be contributed to NewCo must be clearly defined, and mechanisms put in place to ensure that these public service requirements can be met. At the same time, care needs to be taken to ensure that any such controls will not unnecessarily hamper NewCo in fulfilling its objectives or undermine its commercial viability.

1.6.2 Control will often be in terms of the public sector percentage shareholding in NewCo, and particularly whether the public sector is a majority or minority shareholder. However, controls can also be put in place through the governing legal documents, typically the shareholders agreement (see Section 4), and through the governance arrangements (e.g. board membership, advisory councils etc). Consideration needs to be given to the following issues:

- *Public or private sector classification:* Control will be crucial in determining whether NewCo is "classified" to the public or private sectors for national accounting purposes (see Section 2.4). This is a key issue and the decision on

whether the public sector will be a minority, majority or equal shareholder should be taken after careful consideration of all the pros and cons. In most cases, NewCo's founders will want it to be classified to the private sector, because of the greater commercial freedom this brings (see Section 2.5). The public sector partner should, however, be wary of yielding control of NewCo in return for investment alone, and options such as a 50:50 (deadlock) joint venture may be appropriate in some circumstances.

- *Value of assets:* equity in NewCo is given in return for the assets and resources each partner contributes. Under the wider markets initiative, financial investment in NewCo will normally be provided by the private sector. The public sector needs to ensure that its equity share properly reflects the value of the assets (e.g. property, equipment, intellectual property, skills/expertise, goodwill) which it contributes (see Section 5).
- *Protection of investment:* the public sector body needs to consider how it will realise returns on its investment in NewCo, how this investment can be protected if NewCo is unsuccessful and under what conditions it or the private sector partner can exit NewCo and/or NewCo be wound up (see Section 4.12).
- *Future developments and fund raising:* consideration will need to be given to how the public sector interest might change as NewCo develops and/or further share issues dilute the public sector equity shareholding (see Section 6.1).
- *Reputation and public policy concerns:* controls may be needed to protect the public sector body's reputation and ensure that NewCo does not act counter to public policy concerns.

1.7 Key steps in setting up a joint venture company

1.7.1 An overview of typical key steps and actions for the public sector body to take in order to set up NewCo are shown in Figure 2 overleaf.

1.7.2 Before considering the issues set out in this guidance note, it is essential that the public sector body has undertaken an analysis and consultation to assess whether the idea has a sound business plan (product offering, market strategy, competitors etc.) and is commercially viable. This may also involve consultations with the private sector (potential partners, sector experts etc.). Typically, the decision to proceed with the joint venture company option will be made on the basis of an outline business case. Further guidance on these earlier steps is available from Partnerships UK.[11]

1.7.3 It is important that sufficient time and other resources are allocated to the establishment of NewCo. These will vary greatly depending on the size and complexity of the deal. It is, however, unlikely that the process can be achieved without expenditure on external legal and financial advice or take less than several months to complete.

[11] See the Partnerships UK website: http://www.partnershipsuk.org.uk/widermarkets/index.htm. Further guidance is being produced and will be placed on the website as it becomes available.

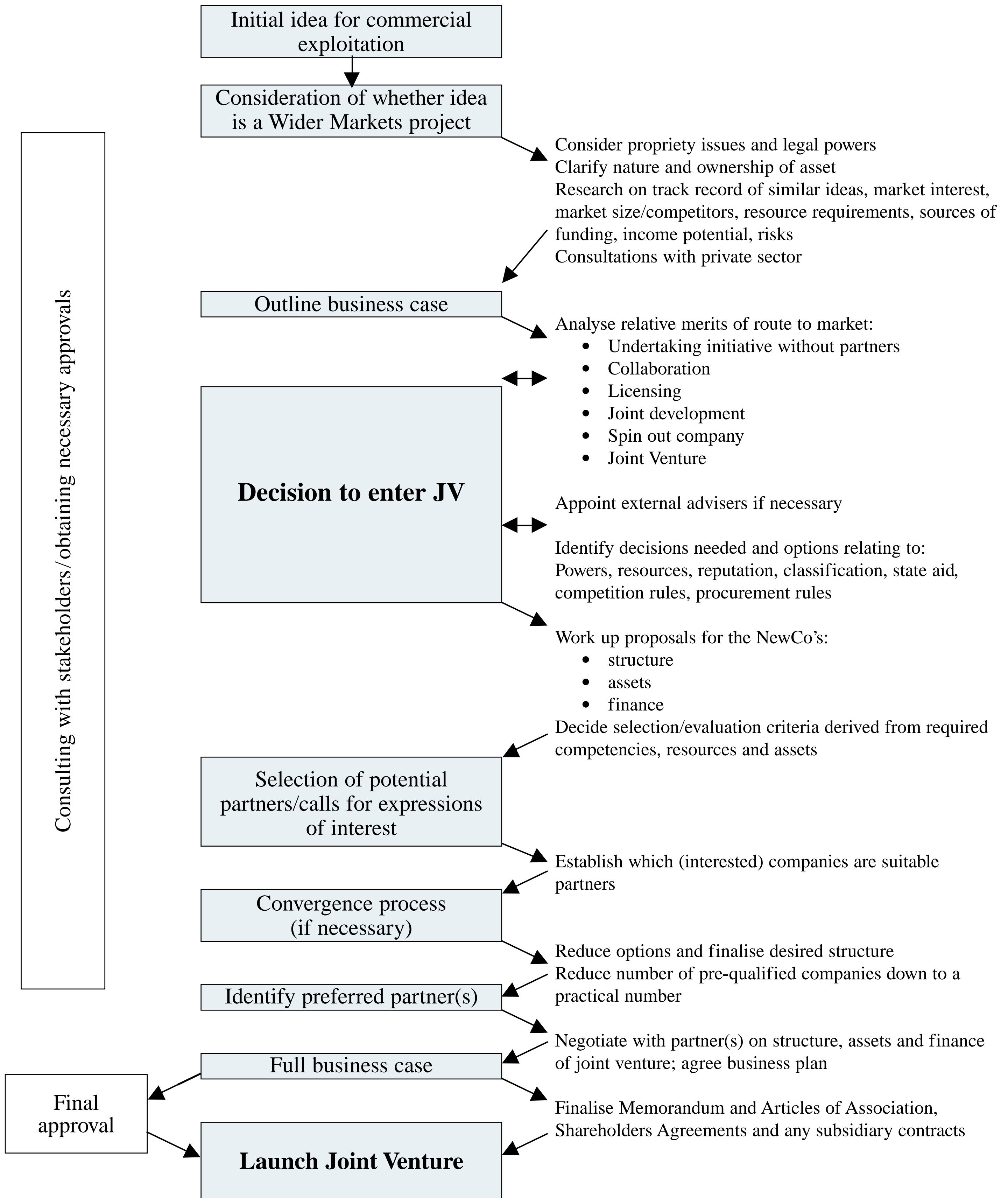
1.7.4 A key aspect for the public sector body to consider when setting up a joint venture is knowing the risks it is taking, and establishing responsibilities for those managing those risks. This will involve obtaining timely information, making contingency plans, and being alert for opportunities. The aim is not to eliminate risk, but to maximise the reward:risk ratio across the risk portfolio.[12] It is also important that the staff of the public sector body engaged in negotiating the joint venture have the necessary skills, or access to those skills through advisers, and have clear responsibilities and a well-thought through incentive structure.

1.7.5 Once the public sector body is convinced that the underlying business fundamentals warrant forming a joint venture company, the decision to proceed with NewCo will depend on a number of issues including statutory powers, reputation, public expenditure and accountability, state aid, competition law, classification and insurance. These are explored further in Section 2 of this guidance. Consideration also needs to be given to how a partner or partners will be selected. Determining the skills, competencies and other attributes needed from the private sector to deliver a particular project is clearly an essential prerequisite to this process. Typical key steps are outlined in Section 3.

1.7.6 Before engaging with prospective partners, the public sector body will also need to consider options, and its requirements and negotiating flexibility, in terms of: NewCo's structure (shareholdings, membership of the board, governing legal documents, termination and exit strategy etc); its assets (valuation of Intellectual Property and staffing contributions) and finance (funding, and division of profits and dividends). Subsequent discussions and negotiations with prospective partners are likely to focus on these sets of issues, and the key considerations for public sector bodies are set out in Section 4 (structures), Section 5 (assets) and Section 6 (financial and other issues).

[12] The NAO backs up this message in its report *Supporting Innovation: Managing Risks in Government Departments,* National Audit Office (http://www.nao.gov.uk/publications/nao_reports/9900864.htm).

Figure 2: Typical key steps and actions for setting up NewCo



2 ISSUES FOR EARLY CONSIDERATION

The public sector body needs to be clear about its constraints or conflicting priorities before proceeding with forming a joint venture company. This section details what the public sector body should consider in terms of:

- Whether it has the legal power to enter a joint venture company for the desired purpose.
- How the joint venture company will be resourced.
- Whether any reputational concerns need to be addressed.
- The consequences of the joint venture company being classified to the private or public sector.
- The application of public sector accountability and expenditure controls to the joint venture company.
- Whether state aid or competition law considerations impact on the joint venture company.
- What commercial insurance is required and considerations about contingent liabilities and guarantees.

2.1 Powers

2.1.1 All decisions or actions by a public sector body must be within the powers *(intra vires)* of that body. Depending on the type of public body, the powers will be set out in one or more of the following: statute, statutory instruments, trading fund orders, company memorandum and articles of association, trust deeds etc; and powers may also exist in common law. If a public sector body acts outside the scope of its powers *(ultra vires)* then that decision or action is invalid and is unauthorised by law.[13]

2.1.2 It is therefore vital that a public sector body planning the formation of a joint venture company should first consider whether it has the necessary powers, including:

- that it has the legal powers to set up a company;
- that it is not using its powers for an improper purpose or unlawfully delegating its powers;
- that it has the powers necessary to cover the business activities of NewCo;
- that it understands which, if any, limitations on its powers will not apply to NewCo – for example, if the public sector body is unable to borrow money, will such limitations affect NewCo?
- that it has monies to spend on NewCo which have been properly voted (if applicable) and has the powers related to other expenditure on it; and
- that it is acting in a way that is compatible with the Human Rights Act.

2.1.3 This is a complicated area and one in which legal advice is often needed. In-house lawyers will be the first source of guidance, as they will be familiar with the source of a body's powers and their application.

[13] An example of this is happening is the Credit Suisse vs Allerdale Borough Council Case. For details, see *Butterworths Local Authority Companies and Partnerships,* Rob Hann, Butterworths, 1998.

2.1.4 Where a public sector body does not have the necessary powers, it should not take the development of the joint venture further unless it is possible to provide for the powers. If the powers can be given, for example, by way of amendments to primary legislation, then it will be advisable not to embark on selecting NewCo's partner until the necessary powers have been obtained. If, however, it is considered necessary to begin partner selection before then, the public sector body must ensure that it complies with any existing limits on its legal powers and spending authority, e.g. when considering options, or undertaking any preliminary work, for the intended project.[14] The public sector should not expect potential partners to commit any significant money to the venture until it is certain that it can proceed.

2.1.5 If the public sector parent of NewCo is a Trading Fund, reference should be made to the specific HM Treasury guidance on Trading Funds' participation in joint venture companies.[15]

2.2 Resources

2.2.1 The outline business case will need to considered the resource requirements for NewCo, including money, assets and staff. These issues are considered further in Sections 5 and 6.

Money

2.2.2 The presumption under Wider Markets policy is that any significant additional capital investment required to deliver the project will be provided by the private sector. Any expenditure incurred by the public sector body on NewCo must come within the powers (see Section 2.1) and expenditure limits of the public sector body and the split of investment between the public and private sectors should reflect the desire to maximise value for money. The investment in NewCo may not all be provided at the outset; issues surrounding future rounds of funding are covered in Section 6.1.

2.2.3 The outline business case will also include assumptions of NewCo's future revenue, based on assumed future prices. Pricing assumptions should not be made without checking on the relevance of government rules such as *The Fees and Charges Guide,* and *Charging for Information: When and How* and other possible legal restrictions such as those contained in *The Competition Act 1998* (see Section 6.2).

Assets

2.2.4 The public sector body will normally have to contribute assets to NewCo, and agree to this in principle at an early stage. It must therefore ensure that it owns the assets, or has the necessary consents or permissions to use the assets and license them to NewCo if required (see Section 5), and that the assets are capable of being used for the intended purpose (e.g. there are no relevant restrictive covenants on land use).

[14] Departments must comply with the new services rules set out in *Government Accounting,* Chapter 2.

[15] *Guide to the establishment and operation of Trading Funds* HM Treasury Central Accountancy Team, January 2001. See footnote 8.

Staff

2.2.5 The public sector body needs to identify the people within its organisation with the necessary skills:

- to negotiate the deal with the private sector;
- to act, if required, as directors of NewCo. Potential directors will need to be made fully aware of their duties as a director (see Section 4.4); and
- to work in NewCo, if appropriate (see Section 5.3).

2.2.6 Where there may be a conflict between the interests of NewCo and of the public sector body, it may be sensible to restrict the participation of the prospective director in the negotiations on behalf of the public sector body.

2.3 Reputation

2.3.1 In order to protect the reputation of the public sector body, its sponsors and stakeholders, the public sector body should consider as early as possible issues where there may be potential for NewCo, in fulfilling its objectives, to make decisions or act in a manner contrary to the public interest. In general, selecting a reputable partner (see Section 3) will help the public sector body maintain its own reputation. Many of the propriety considerations in selecting a partner will be the same as for commercial sponsorship of government activities and are set out in Cabinet Office guidance.[16] Consideration should also be given to ensure civil servants act in line with the principles of public life identified by the Committee on Standards in Public Life.[17]

2.3.2 Reputation is more likely to be an issue in some sectors than in others. For example, the public sector body may be concerned to ensure for national security reasons that it knows the identity of all NewCo's customers and can veto the right of NewCo to enter into contracts that, in its opinion, may be contrary to national security interests. There may be reputation concerns also about creating relationships between, for example, public sector health and tobacco companies. Reputational issues could also arise if NewCo is seen to be paying excessive salaries.

2.3.3 The public sector body will also need to consider the potential implications if NewCo will be competing against other companies to provide goods or services to the public sector parent.

2.3.4 Protection may be needed if NewCo's name is closely linked to that of its public sector parent. In such cases, the public sector parent will need to ensure that it can insist on a change in the name of NewCo if it ceases to have a significant interest in the company.

[16] *Guidance to Departments on Sponsorship of Government Activities,* Cabinet Office, July 2000. Available at the Cabinet Office website: http://www.cabinet-office.gov.uk/central/2000/Sponsorship%20Guidelines.htm

[17] The seven principles are: selflessness, integrity, objectivity, accountability, openness, honesty and leadership. See the Committee on Standards in Public Life website at: http://www.public-standards.gov.uk/.

2.3.5 If any genuine issues are identified, the public sector body will need to consider the most suitable approach to alleviate its concerns and protect its reputation or other concerns.

2.3.6 Depending on the relevant issue, protection could be sought as outlined below:

- an express provision in the Shareholder Agreement imposing a contractual obligation on NewCo and/ or the private sector partner;
- a provision in the Memorandum and Articles (e.g. the objects clause which sets out the nature of the business);[18]
- reservation of the matter to be decided by the Shareholders, and an express right of veto attached to the class of shares held by the public sector (whatever the % shareholding of the public sector party); or
- adoption by NewCo of a specific "corporate policy".

2.3.7 The public sector body should ensure that the controls it puts in place do not undermine the NewCo's ability to be effective in delivering the objectives for which it is being established. The public sector body will also need to keep in mind that if it includes too many controls, it may affect whether NewCo is classified to the public or private sector.

2.4 Classification

Introduction

2.4.1 Public sector bodies will need to consider a number of questions early on regarding NewCo's classification, and subsequently keep them under review. The main issue of classification will be whether NewCo is considered a public or private sector body in the UK's national accounts. Beyond this, other classification issues may also be important; these can affect the sector classification of the body and the classification of its transactions. The separate issue of whether or not NewCo is a "contracting authority" under EU public procurement rules is dealt with in Section 6.4.

2.4.2 All companies need to be classified by sector for national accounts purposes, either to the private or to the public sector. Classification does not mean it is 100% owned by a given sector.

2.4.3 The body responsible for determining the classification of companies into public or private sector is the Office of National Statistics (ONS). It makes its decisions in accordance with the guidelines in the European System of Accounts.[19]

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[18] It should be noted that provisions in the Memorandum and Articles of Association can be changed by a party with more than 75% ownership of NewCo (Companies Act 1985, as amended by Companies Act 1989).

[19] For further details on the ONS procedure, ESA system and individual classifications see http://www.statistics.gov.uk/themes/economy/Articles/NationalAccounts/SectorAccounts/sectorclassification.asp.

Procedure

2.4.4 If the public sector owns more than 50% of the voting shares of NewCo, it will have control, and NewCo will be classified to the public sector.

2.4.5 In cases where the public sector owns 50% of NewCo's voting shares or fewer, a key issue will be who has control over the appointment of the directors. This can refer to the simple majority of directors, or the key directors who determine the policy of an organisation. A right to be consulted over appointments, or to have a veto over appointments, does not necessarily give control. Nevertheless, where a new body is being formed that is intended to be in the private sector, any government involvement in appointments should be kept to a minimum. The ONS may also take into account other factors such as golden shares, veto rights etc. (see Annex A).

2.4.6 If a body is a 50/50 (deadlock) joint venture with neither partner having overall control over the Board, then it would normally be classified to the private sector, but the ONS would look very closely at such cases to check whether the public sector partner had any extra powers beyond those needed to protect its financial interest.

2.4.7 A prospective NewCo concerned about its national accounts classification should in the first instance contact HM Treasury.[20] HM Treasury will settle more straightforward cases, and pass more complicated ones to ONS if necessary. HM Treasury has issued a guidance note on classification to the public or private sectors, which sets out the key issues in some detail.[21] The public sector body should look to clarify the issue of NewCo's intended classification, as far as is practical, before engaging formally with the private sector.

2.4.8 There is no mandatory procedure for a NewCo to notify HMT or ONS of its planned classification status. The ONS will make an initial decision where a new organisation will fit in the national accounts, and revisit this decision if the degree of public sector control appears to have shifted.

Implications

2.4.9 The main implications of public or private classification are:

- *public expenditure controls and accountability* (see Section 2.5): public sector bodies may be subject to Parliamentary scrutiny, Government Accounting rules, public expenditure control and disclosure requirements (including requirements of the Public Records Act and the Freedom of Information Act). For private sector joint venture companies, parliamentary accountability would usually be restricted to public money invested or granted to the venture;
- *attractiveness to private sector partners:* a private sector classified joint venture company is likely to be more attractive to private sector partners; and

[20] The Classification Branch in the General Expenditure Statistics team (telephone 020 7270 5337).

[21] *Classification of Expenditure – Public and Private Sectors: New bodies, Partnership, Joint Ventures, Privatisation and Nationalisation,* Class (2000)1, HM Treasury. Available from the Partnerships UK website: http://www.partnershipsuk.org.uk/widermarkets/linksaz.htm.

- *public sector interests:* public sector classification implies a greater degree of control by the public sector founder. However, a private sector classification could still allow sufficient scope to secure public sector financial and other interests through NewCo's founding documents.

2.4.10 It is important to remember that a classification in the public sector does not make the public sector founder liable for NewCo's debts, any more than a private sector classification makes the private sector liable. The principle of limited liability will apply equally to all shareholders.

Box 3: Examples of complicated classifications

- Most universities are classified to the private sector, despite large-scale government funding.
- Nirex Ltd was previously owned by a number of different public and private organisations (BNFL, Magnox Electric, British Energy, the UK Atomic Energy Authority, with one special share belonging to the DTI). Although it had no majority shareholders, it was judged overall to be in the public sector. This situation has now been made clearer by the merger of BNFL and Magnox, which now means that Nirex is majority-owned by the public sector BNFL group.
- Partnerships UK is owned 49% by public sector bodies (HM Treasury and Scottish Ministers) and 51% by private sector bodies (initially 11 different shareholders). It has a public sector mission, and an advisory council made up of public sector stakeholders who report to HM Treasury on Partnerships UK's effectiveness in fulfilling its public sector mission. HM Treasury's shares have certain special rights, including the right of consent over any change to Partnerships UK's public sector mission. However, Partnerships UK has been judged to be in the private sector, as the overall balance of control on its board is in the private sector.

Source: Partnerships UK, Nirex Ltd, ONS

Delineation within the public sector

2.4.11 Within the public sector, there are three sub-sectors to which a body can be attributed in the national accounts: central government, local government and public corporations. A public sector body will count as a public corporation if it produces goods and services for sale and at least 50% of its income is derived from sales.[22] A NewCo formed to exploit a wider markets opportunity that is classified to the public sector is therefore likely to count as a public corporation.

[22] Note that this definition of public corporation is not the same as the legal definition.

2.5 Public expenditure and accountability

2.5.1 The application of Government Accounting and public expenditure controls to NewCo will depend on whether it is classified to the public or private sector (see Section 2.4), and, if public sector, on what type of public sector body NewCo will be.

Private sector classified joint venture companies

2.5.2 In most cases, NewCo's founders will want NewCo to be classified to the private sector, because of the greater commercial freedom this brings. Any public sector expenditure (such as subsidies, investment grants and loans) on NewCo will be included in the Estimates and Accounts of its sponsoring body. Substantial investment in NewCo should normally be undertaken by the private sector for a Wider Markets project. Under the policy set out in *Selling Government Services into Wider Markets: Policy and Guidance Note,* departments have the automatic right to retain the benefits of revenues and dividends from Wider Markets activities including joint ventures companies. Receipts can be used to offset administration expenditure in proportion to the administration cost element of the expenditure.

2.5.3 Public sector bodies need to ensure they have the necessary statutory powers (see Section 2.1) and authority through Estimates to incur expenditure and receive receipts on NewCo, or become exposed to other liabilities such as through indemnities, which may require a change to the ambit of the vote. Even if NewCo is classified to the private sector, the relevant Accounting Officer will be responsible for regularity, propriety and value for money of public expenditure on NewCo. Any such expenditure, and information relating to it, will be subject to scrutiny by Parliament and the Comptroller and Auditor General.

2.5.4 All joint venture companies will be subject to the statutory rules set out in the Companies Acts.

Additional controls for joint venture companies classified to the public sector

2.5.5 If NewCo is classified to the public sector, it will be subject to accounting and public expenditure controls in addition to those listed above for private sector joint ventures.

2.5.6 A NewCo classified to the public sector is likely to be treated as a public corporation (see Section 2.4). As such, its profit/loss, capital expenditure, and a cost of capital charge[23] on its net assets, will need to be recorded against the sponsoring department's Departmental Expenditure Limit (DEL), even if they are financed by the private sector partner. It would therefore normally be necessary for the public sector founder to set financial targets for NewCo to break even and provide a set rate of return on capital employed. Exceptionally, some public corporations are defined by Treasury as Self Financing Public Corporations (SFPCs) and count in the sponsoring department's Annually Managed Expenditure (AME), but even in those cases it is still necessary to set targets for the rate of return on NewCo's assets.

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[23] Cost of capital charges are currently within Annually Managed Expenditure (AME) but will be treated as part of the Departmental Expenditure Limit (DEL) from the Spending Review 2002.

Accounting treatment

2.5.7 All joint venture companies will be subject to the UK Generally Accepted Accounting Practice. The way in which the results and assets and liabilities of NewCo are recorded in the accounts of the public sector parent will depend on its relationship with NewCo (the extent of its involvement in the day-to-day management of NewCo) and whether the public sector body is included in the resource accounting boundary.

2.5.8 For accounting purposes, the public sector parent's relationship with NewCo can be classified as that of a subsidiary, associate or 'joint venture' (in a narrower sense than used elsewhere in this guidance). The way in which subsidiaries, associates and 'joint ventures' should be incorporated on the parent bodies' accounts is summarised in Annex D.

2.5.9 Public sector subsidiaries, associates and 'joint ventures' will be consolidated into Central Government Accounts and/or Whole of Government Accounts in due course.[24]

Audit

2.5.10 As NewCo is a limited company, private sector auditors will be appointed to audit the accounts of NewCo. The public sector parent's auditor (whether the Comptroller and Auditor General or a private sector auditor) will also look at the public sector parent's expenditure and income on NewCo, as well as the financial information on NewCo which appears in the public sector body's accounts (see Annex D). The public sector body's auditor may need to go behind these figures to ensure that they provide a true and fair view of the public sector body's accounts. To do that the auditor may look to NewCo's own auditors in order to obtain assurances.

2.6 State aid

2.6.1 The European Commission has considerable powers to monitor, control and ultimately prohibit the forms and levels of aid provided to commercial undertakings by EU Member States and to require the repayment of state aid which has been unlawfully granted. The concept of state aid covers the more obvious forms such as government grants to companies, but also indirect forms, including:

- any kind of financial support to small firms;
- making equity investments, loans or guarantees;
- providing help with premises or training; or
- undertaking measures to promote urban regeneration.

[24] For details of the Whole of Government Accounts Programme see www.wga.gov.uk.

2.6.2 It should be stressed that state aids rules need not be a large hurdle to overcome, especially if NewCo is set up with the rules in mind from an early stage in the project. In order to count as a state aid, a specific measure has to meet the four key tests outlined in Annex B; even if it does meet all four, the measure will not necessarily represent unlawful state aid, as there are a number of exemptions, guidelines and frameworks which may apply. A specific measure is where a recipient receives a benefit which they would not have received in the normal course of business.

2.6.3 The DTI produces thorough guidance on the state aid rules, revised most recently in 2001.[25] The application of the rules can be complex and if there are any doubts related to specific projects these should be addressed at an early stage (for example, while preparing the outline business case) to the State Aid Policy Unit at the DTI.[26]

2.7 Competition law

2.7.1 Competition laws are likely to apply to NewCo regardless of its classification, as it will be engaged in commercial or economic activities and thus is likely to come under the definition of "undertaking" in both UK and EC competition law.[27] This will apply even if the public sector partner in NewCo is not itself an "undertaking".

2.7.2 Public sector bodies wishing to establish joint venture companies should not see competition law as a barrier, especially if their activities are aimed at increasing competition in a market. All businesses in the UK have a similar obligation to abide by competition legislation. However, this is an area in which many public sector bodies will be less familiar, particularly if this is their first foray into commercial activity.

2.7.3 Annex C provides information on the two main aspects of competition law to be considered when setting up NewCo:

- merger control (under the 1973 Fair Trading Act and the EC Merger Regulation); and
- anti-competitive agreements (the Chapter I prohibition of the 1998 Competition Act, and Article 81 of the EC Treaty).

2.7.4 A further aspect of competition law, abuse of a dominant position in a market, may also be relevant after NewCo has been set up, particularly if the activities of NewCo are in a niche or uncompetitive area. This is discussed further in Section 6.2.

2.7.5 The public sector body and private sector partner should ultimately ensure that they are compliant with the UK Competition Act (or other competition laws) in conjunction with their legal advisers. The Office of Fair Trading (OFT) has provided guidance to explain how the various competition laws apply.[28] It can also provide informal advice to help in the determination of such issues.

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[25] Available at the DTI website http://www.dti.gov.uk/europe/stateaid/guide/index.htm.

[26] DTI State Aid Policy Unit, email: sapu@dti.gsi..gov.uk or telephone 020 7215 4498.

[27] *See Public Sector Bodies and the Competition Act 1998,* Office of Fair Trading. Available at the OFTwebsite: http://www.oft.gov.uk/html/comp-act/download/oft440.pdf.

[28] Available from the OFT website: http://www.oft.gov.uk/html/comp-act/technical_guidelines/index.html.

2.8 Commercial insurance

2.8.1 Public sector bodies do not usually need to take out commercial insurance.[29] In the context of the Wider Markets Initiative, however, some amendments have been made to *Government Accounting* in order to enable public sector bodies to take out commercial insurance in some circumstances.[30] NDPBs are allowed to purchase commercial insurance in relation to their income generation schemes (including Wider Markets activities). Government departments and executive agencies can buy commercial insurance for risks associated with Wider Markets activities, without consulting HM Treasury. This is in order to prevent any serious losses arising from their Wider Markets activities from jeopardising the resources available for the core activities. These derogations are not intended to affect the general policy of government self-insurance. Exceptions to this general policy must be based on sound value for money reasons.

2.8.2 A public sector body should seek advice on the appropriate commercial insurances available to protect it against the potential liabilities which could arise from setting up and operating NewCo. Action should be taken to reduce the risks and liabilities, for example by ensuring that obligations are clearly defined and that there is sound evidence to back any claims the public sector makes about the assets it is contributing to NewCo. Nevertheless, NewCo, the private sector partner(s), or others, may bring a claim against the public sector body, for example:

- for breach of any of its obligations under the shareholder agreement;
- for breach of any of its obligations under a licence or concession agreement entered into with NewCo;
- for breach of any warranty, for example relating to ownership of any asset transferred or licensed to NewCo; or
- for a misrepresentation as to the extent and viability of the market for NewCo's activities.

Box 4: CEFAS joint ventures and insurance

The Centre for Environment, Fisheries and Aquaculture Science (CEFAS) is an Agency of the Department for the Environment, Food and Rural Affairs. It has equity stakes in two joint venture companies, set up under the Wider Markets Initiative.

In March 2000 it launched a joint venture company called Eco-Sense, 49% owned by CEFAS and 51% by W.S.Ocean Systems, a manufacturer of underwater scientific research equipment. Eco-Sense has been set up to exploit CEFAS technology in marine observation systems.

In June 2001 it set up a joint venture company with Kiotech. The new company is called Ultrabite, and will market CEFAS' patented fish attractant.

CEFAS has taken out insurance both for directors' liabilities and, in the case of Ultrabite, for its claim that the fish attractant is effective. This second piece of insurance was thought necessary as the claim was used to help raise funding.

Source: Partnerships UK, CEFAS

[29] *Government Accounting,* Chapter 30.

[30] D.A.O. Letter, 29 November 2000, amending paragraphs 27.2.13 and 27.3.4.

2.8.3 If any of the directors of NewCo are civil servants employed by the public sector body, insurance should be taken out in relation to their liabilities as a director.

2.8.4 NewCo will be responsible for taking out appropriate insurance to cover its activities.

2.9 Contingent liabilities and guarantees

2.9.1 Any public sector body to which *Government Accounting* applies will need to be aware of their obligations to Parliament where accepting potential liability outside normal core business activities.[31]

2.9.2 The public sector body needs to consider carefully the implications of providing guarantees or warranties, or indemnifying NewCo against any risks. It should avoid taking any actions which give rise to any unnecessary potential liabilities. In addition to this being good sense, where any representations, warranties or indemnities are provided it must confirm that is has the necessary powers to do so (see Section 2.1). Where guarantees and the like are provided, the public sector body should consider the need for financial cover (see Section 2.8).

[31] see *Government Accounting* Chapter 26.

3 SELECTION OF THE PRIVATE SECTOR PARTNER

Public sector bodies will have to choose how to select their partner and what process to use for selection. This section addresses:

- The practical steps to be taken to select a partner, and the need to ensure such steps comply with relevant policy and legal requirements.
- The use of selection criteria to evaluate potential partners.
- How confidentiality agreements may be used during the selection process.
- Decisions on the governing law and jurisdiction for the joint venture company.

3.1 The selection process

3.1.1 The process of selecting a partner will need to be tailored to meet the business objectives of NewCo and will depend on the nature of the asset. Unlike many procurement processes, considerations other than compliance and price may be equally if not more important. For NewCo to be successful, it will need to be a genuine partnership between the public and private sector shareholders and so the process of selecting a partner will involve negotiations to reach commonly agreed objectives and goals.

3.1.2 In setting up NewCo the public sector body will itself need to put together the right team to manage the process and consider the support that it will need to conduct the process effectively.

Policy requirements

3.1.3 A public sector body seeking to select a private sector partner in NewCo will need to determine (a) the impact of the government's value for money policy upon their proposed course of action, and (b) whether the legal requirements of the EC public procurement rules apply.

Value for money

3.1.4 Government policy requires public sector bodies to obtain value for money in their use of public monies. The National Audit Office (NAO) oversees public expenditure (see Section 2.5), and has a remit to look beyond just expenditure and report to Parliament on the economy, efficiency and effectiveness with which Government bodies have used public money.[32] Even when the majority of the financial investment in the joint venture is being sought from the private sector, there is an obligation on the public body to extract best value from the asset which is being exploited. The selection of the best and most appropriate partner(s) will play a fundamental role in achieving this obligation.

3.1.5 Value for money can be difficult to assess in selecting a partner for a joint venture company. Value for money considerations should include issues such as which partner is most able to provide the required assets, how risks are handled and prospects for long term revenue generation as well as how much value prospective partners are willing to place on the public sector asset.

[32] The Public Accounts Committee has criticised departments for not using competitive processes for contracts and partnerships. See for example, *Committee of Public Accounts Session 1993-4, Third Report.*

3.1.6 Ideally, the best way to obtain and demonstrate that best value will be delivered from the public sector input into NewCo is to run a competition to select a joint venture partner; in particular:

- Competition is likely to be the best, and in some cases the only, way to test the market and establish a justifiable price for the public sector's contribution to NewCo.
- A well-run competition will allow the public sector to demonstrate that it has sought and achieved best value.
- The chances of a challenge under the state aid rules may be reduced (see Section 2.6), although holding a competition is in itself no guarantee that the requirements of state aid rules have been met.

3.1.7 However, a transparent approach through an open competition will not be the best process for selecting a partner in all cases and alternative approaches can be used if they are justified. An open and transparent competition is likely to be most appropriate where the business opportunity is well understood and it can be clearly defined. For other projects, where for example the opportunity is based on new knowledge and there are business considerations around being first to market, it may be more appropriate to target potential partners. In other instances, the ownership of intellectual property or specialist assets may limit the number of potential partners (e.g. where there has been a development agreement leading to joint ownership of intellectual property).[33] There will also be projects where it will be better to approach prospective partners rather than calling for information and bids. The overarching aim is always to ensure best value, bearing in mind the benefits that an open and competitive environment can deliver.

3.1.8 In cases where a private sector partner approaches a public sector body with an innovative idea, which it does not want advertised more broadly (for example, if it has any intellectual property to protect), public sector bodies should take appropriate steps to protect the intellectual property of the potential partner (see Section 3.3). If a competitive process follows an approach with an innovative idea, the process should be designed to test whether the market can deliver alternative propositions rather than competing claims based on the original innovative idea.

EC procurement rules

3.1.9 The EC public procurement rules[34] make particular requirements of public sector bodies which are "contracting authorities" (see Section 6.4).[35] In most cases, the view taken in the UK is that an agreement to establish a joint venture company for a Wider Markets opportunity in itself is unlikely to constitute a contract for goods, services or works, and as such the EC procurement rules should not apply. However, the distinction between partnership arrangements involving a procurement and those not involving a procurement is not always clear cut, and every case should be looked at individually. For example, if there are contracts for services between the public sector and private sector parties engaged in NewCo, the EC rules may well apply to such contracts, and account needs to be taken of this in structuring the selection process for

[33] Note that public sector bodies should therefore be careful about taking actions which may limit future competition.

[34] Implemented in the UK by Statutory Instruments 1991/2680, 1993/3228, 1995/201, 1996/2911, 2000/2009.

[35] The Office of Government Commerce (OGC) publishes best practice guidelines on procurement-related issues.www.ogc.gov.uk/OGC/procurement.nsf/pages/procurement.html.

the joint venture partner. In complex cases, the issue of whether the rules apply will ultimately need to be considered by lawyers (usually the in-house legal adviser). Where they do apply in full, public sector bodies must comply with specific transparency, non-discrimination and competition provisions for contracts above specified value thresholds.[36]

3.1.10 Even where there is no strict requirement to apply the EC rules to their selection of a partner the principles derived from the EC treaties[37] may apply and public sector bodies may wish to consider voluntary compliance with the rules. This has the advantage of being a well-known route for finding a private sector partner, and can avoid subsequent difficulties if it turns out that NewCo does need to enter into a contract for services (if, for example, the nature of the joint venture company agreement changes during negotiation). However, there may be some disadvantages to voluntary application of the EC procedure, in particular if it is not made clear precisely which parts of the process are being followed. For example, voluntary application raises the possibility of implied contractual obligations, which, if breached, could provide bidders with a right of challenge.

Typical selection processes

3.1.11 There are broadly two methods of selecting a partner competitively: running an open competition or using a targeted approach. As discussed earlier in this section, the choice of approach will depend on the particulars of the case. The overall aim, whatever process is followed, is to select the partner best able to deliver the sought-after outcomes. Both processes have much in common, and should involve:

- identifying and investigating the market (considering type, geography, size, players, strategy etc);
- identifying and investigating the main players (considering philosophy, track record, geography, strategy, market share, marketing skills, competitors etc);
- developing evaluation criteria based on the desired competencies, attributes and the desired strategic outcome;
- shortlisting; and
- identifying and negotiating with a preferred partner.

3.1.12 The public sector body will need to consider the timetable for each of these stages and how many potential partners should be shortlisted and how many to enter negotiations with. The public sector body will also need to consider the extent to which it is able to control the selection process. For example, in some cases the public sector may have to react quickly to proposals from potential private sector partners. The timetable and conduct of the selection process will also depend on whether the EU procurement rules apply, and the time and resources that it is appropriate to spend on forming NewCo.

[36] See, for example, the *Radiocommunications Agency's joint venture with CMG, Report by the Comptroller and Auditor General,* (available at http://www.nao.gov.uk/publications/nao_reports/00-01/000121.pdf), or for a local authority example, *Lambeth Case Study,* 4Ps (available at http://www.4ps.co.uk/the4ps/lambeth.pdf).

[37] The five principles are: non-discrimination, transparency, equal treatment, mutual recognition and proportionality.

3.1.13 An open competition differs from a targeted approach in the way that information about the opportunity is disseminated, and in the way that potential partners are asked to respond. Typical steps include:

- announcement of the competition, advertising, and calling for expressions of interest;
- a pre-qualification process to establish which of those entities which expressed interest are suitable for inclusion in competitive process;
- if necessary, an outline proposal stage, where entities are invited to respond to more detailed information about the opportunity, or other form of convergence process, in order to bring the number of pre-qualified bidders down to a number suitable for a final stage of competition; and
- a formal tender/invitation to negotiate.

Box 5: Radiocommunications Agency joint venture partner selection

In 1995 the Radiocommunications Agency decided to enter a partnership with a private-sector IT supplier, both to supply some IT services and to help exploit the Agency's expertise in spectrum management systems. The Agency initiated a study to define the partnership in April 1995, and the market soundings taken as part of this process showed that there was likely to be significant interest.

The Agency advertised in OJEC for potential partners in February 1996. This generated 56 expressions of interest. From the 22 companies that replied to a follow-up questionnaire, the Agency selected a long-list of 12 potential bidders. In August 1996 the Agency issued an "Outline Specification", which generated 6 responses. At this point the Agency refined its thinking on the nature of the partnership it was looking for and decided it would like to set up a joint venture company. By the time that the "Full Specification" was issued in April 1997, 5 of the 6 bidders had reservations about the deal, and in the end only 2 submitted bids. The main reservations appear to have been linked to the fact that one of the bidders, CMG, was already working for the Agency developing spectrum management IT systems, and was therefore perceived to have an advantage over the others in the competition.

Of the 2 bids received, one was an alternative bid, proposing to separate out the IT services and the exploitation of the Agency's expertise into 2 deals, rather than keep them in the one joint venture company. The Agency rejected this bid, leaving only CMG left in the competition. However, at this stage there had been no pricing of bids, making the ensuing negotiations with CMG very difficult. The contract was finally signed in June 1998, after negotiations with CMG lasting 9 months.

Despite the problems encountered in selecting a partner, the NAO's report on the joint venture concludes positively. The joint venture has facilitated savings of approximately £1m per year for the Agency and several key risks have been transferred to CMG; the Agency is also receiving dividend payments from the company.

Source: Partnerships UK, NAO

3.1.14 Where a targeted approach is more appropriate, the public sector body should aim to follow a structured selection process similar to an open competition, but which carefully selects to whom information should be released.

3.1.15 Raising awareness of the opportunity, and building up credibility with potential partners can be achieved either through private exposure (e.g. through face to face meetings) to a number of potential partners on the shortlist, or through public exposure through the press, trade shows etc. Care should be taken to ensure that the method chosen for raising awareness is the best route for a given situation. The public sector body should avoid:

- any premature exposure which could damage the IP position; and
- exposure which could affect the market and provide enough information to competitors to reduce or nullify the potential market opportunity.

3.1.16 The ensuing negotiations and building of relationships with interested partners (with as many as possible until the deal is complete) can be a costly process. Negotiations with targeted partners should normally take place under a non-disclosure agreement (see Section 3.3).

3.2 Criteria for selection

3.2.1 As part of its early considerations, the public sector body needs to be clear about the qualities, characteristics and assets it is looking for in private sector partners for NewCo. Part of the rationale for establishing NewCo will be to access private sector assets which are needed for successful commercial exploitation, but which may not be available in the public sector body (e.g. financial resources, technological expertise, marketing skills, access to customers and markets etc.). However, for NewCo to be successful, it is also important for partners to have the right qualities on "softer" issues, such as cultural fit and relationship management, which are typically harder to evaluate. Public sector bodies also need to consider the reputation and potential conflicts of interest of partners (see Section 2.3).

3.2.2 These characteristics and assets should form the basis of the selection criteria used to target potential partners or create a shortlist. Consideration will also be needed on criteria to decide on the preferred partner. Criteria may be weighted and scored, in order to help increase the objectivity of the final decision although this will not always be appropriate.[38]

3.2.3 Some criteria and possible areas of questioning are set out in Table 1. Information provided should be complemented using other documentation, such as Annual Reports and audited accounts. In most circumstances, public sector bodies should consider using external advisers to help in partner appraisal. Annex C of the *Selling Government Services into Wider Markets: Policy and Guidance Note* provides further useful guidance and key questions relating to partner selection and appraisal.

3.3 Confidentiality

3.3.1 As part of the partner selection process, the public sector body may issue detailed documentation about the proposed business of NewCo. Before doing this, it should consider carefully the merits of making prospective partners sign confidentiality agreements. Where the business of NewCo is linked to new technology, it is probable that non-disclosure agreements will be needed. Such confidentiality agreements should cover key areas such as:

- the purpose for which the information is being provided, and the stipulation that the information can only be used for this purpose;
- identifying the people in the recipient organisation to whom the information may be disclosed;
- obligations to keep the information confidential; and
- arrangements to return documents at the end of the prospective partner's involvement.

[38] If the public procurement rules apply, then there are EC procurement rules for selection and award criteria, especially with respect to any pre-qualification process, which must be followed. See the OGC website: www.ogc.gov.uk/ogc/procurement.nsf/pages/CUPGuidance.html (in particular no.51).

Table 1: Possible partner selection criteria

Characteristic/Asset	*Possible questions/selection criteria*
Relationship Management	Vision: why they want to get involved Objectives: what they want to get out of the partnership Stated policy on partnering Transparency in dealings
Organisational strengths	Company background Principal activities Management capacity Ownership structure: parent and subsidiaries Core business Stability of market place in which company operates Diversity of operations Performance and reliability within market place
Financial strengths	Statement of turnover in respect of proposed joint venture company Key ratios: profitability, liquidity, gearing, debtor delays, stock turnover
Technical capability	Questions/criteria will depend on the specifics of the project

3.3.2 Likewise, approaches made by prospective private sector partners may also contain confidential information and public sector bodies may be asked to sign confidentiality agreements. The public sector body should take care that any such agreements do not create an unwanted long-term exclusive arrangement. Agreements should therefore be limited in duration.

3.3.3 In general, confidentiality should not be used to hide the commercial nature of the resulting deal. Any agreements that attempt to do this should be defensible to Parliament on public interest grounds.

3.4 Governing law and jurisdiction

3.4.1 In some cases consideration may be given to registering NewCo outside the UK, perhaps because a potential private sector partner is not UK-based.

3.4.2 This guidance is focused on the law of England and Wales for both incorporation of the company and the jurisdiction for dealing with disputes. Certain joint ventures may wish to be governed by other appropriate legal systems, such as Scottish or Northern Irish law.

3.4.3 Relevant UK governing law (England and Wales, Scotland or Northern Ireland) should be used unless there are very good reasons otherwise. Public sector bodies should consult carefully with their legal advisers before agreeing to enter into a NewCo governed by non-UK law. Investigating the implications of incorporating NewCo in a foreign legal jurisdiction or agreeing a foreign-based dispute resolution procedure is likely to be expensive and time-consuming.

4 STRUCTURING THE JOINT VENTURE COMPANY

This section describes some of the decisions that a public sector body needs to make in establishing NewCo and its business, to ensure that the structure fulfils the public sector body's objectives and a deliverable commercial solution. In particular:

- The percentage shareholding of each partner.
- Different types of shares.
- Ways in which the joint venture company can be managed.
- Directors' rules.
- Corporate governance considerations.
- Policies on the payment of dividends.
- The legal documents governing the joint venture company.
- The role of the business plan.
- Minority Shareholdings.
- Dealing with potential deadlock situations.
- Strategies and controls for the shareholders to exit the joint venture company.

4.1 Percentage allocation of shares

4.1.1 The size of the public sector shareholding of NewCo will be a key issue which must be considered at an early stage. Although there are no standard rules on how to allocate shares, legal and financial advisers should be able to advise on an appropriate structure. Considerations include:

- The equity holding justified by the value of assets (whether cash or non-cash) and/or contracts contributed.
- The level of control required over the company (see Section 1.6 and also Section 4.9 on minority shareholding).
- The impact upon the public sector or private sector classification of NewCo (see Section 2.4).
- Possible dilution through future share issues.

Table 2: Types of joint venture shareholding structure

Types of Structure % Shareholding Private Sector Partner: Public Sector Body	Comments
50:50 %	Both parties have an equal shareholding. With this type of structure it is usual for the parties to have equal management and voting rights. This means built in potential for deadlock; where no decision can be made as each shareholder takes an opposing view.
more than 50 % : less than 50%	Even though the private sector partner holds the majority of shares the public sector body can still build in adequate protections through its voting rights at board and shareholder level (see Sections 4.3 & 4.9).
less than 50% : more than 50 %	As a majority shareholder the public sector is deemed to 'control' NewCo. This will have important implications for purposes of classification (see Section 2.4).

4.1.2 If the exact percentage of public sector shareholding is left open to negotiations with potential partners, consideration will be needed on how proposals for different levels of shareholding will be evaluated.

4.1.3 Table 2 above shows some different types of structures where there are two shareholders.

4.1.4 Under the Wider Markets Initiative a public sector body will usually be making a non-cash contribution to the joint venture company. It is important to note that in the particular case where NewCo will be a public limited company, it is obligatory to have the non-cash contribution independently valued (but see also Section 2.6 on state aids). In order to avoid the situation where shares are being issued at a discount, the value of any non-cash contribution must be not less than the nominal value of the shares being issued in exchange.

4.2 Types of shares

4.2.1 A subscription for ordinary equity shares is the simplest and most common way to capitalise a joint venture. This subscription can be in the form of a capital or non-cash (assets, IP etc.) consideration. However, UK law provides a flexible system in which various types of shares can be issued with different rights associated with them. Shares of the same type are referred to as a "class".

4.2.2 An example of this is preference shares, which may give, for example, priority over other ordinary shares for the payment of dividends. Other rights that may attach to shares include the number of directors that the shareholder has a right to appoint to the board or a right of veto or approval over certain matters to be decided by the shareholders.

4.2.3 Whether it is appropriate for each shareholder to subscribe for the same class of shares or for certain shareholders to have a different class of shares with specific rights attached will depend upon the particular circumstances. Different classes of shares with differentiated rights and restrictions can be used to protect the interests of the public sector body, particularly where it is a minority shareholder. The extent of control on NewCo exerted through such class rights may affect its classification.

4.3 Managing the joint venture company

4.3.1 The public sector body and private sector partner must decide how NewCo is to be managed. The shareholders' agreement and Articles of Association (see Section 4.7) will need to be tailored accordingly.

4.3.2 The structure of NewCo will influence how it is to be managed. For example, a 50:50 joint venture is often deliberately structured so that both parties have equal representation on the board and equal voting rights. This structure has in-built potential for deadlock where no decision can be made if each party takes an opposing view. Where the shareholders hold unequal shareholdings, a majority shareholder will expect to have a final say on matters to be decided at board, whilst a minority

shareholder will need to consider what special rights it may need in order to protect its position (see Section 4.9).

Shareholders

4.3.3 The shareholders will need to decide the degree of active involvement (the extent of governance) they wish to have in NewCo. They will need to protect the interests (and investment) of the shareholders while providing the necessary degree of autonomy for those responsible for managing NewCo.

4.3.4 A shareholder can be involved in NewCo in a number of ways: voting at general meeting; exercising rights of approval or rights of veto over those matters the shareholders have agreed to withdraw from the remit of the board; or through specific contractual provisions agreed between the shareholders and set out in a shareholders' agreement.

4.3.5 The public sector body will need to consider:

- those matters (if any) to be withdrawn from the remit of board to be approved by the shareholders; and
- those matters (if any) over which it wishes to have veto rights.

4.3.6 These should be kept to a minimum. However, if the public sector body is a minority shareholder there are key issues which it will need to address (see Section 4.9).

Board of directors

4.3.7 Responsibility for the supervision and management of NewCo and its business lies with NewCo's Board of directors, except for those matters which UK company law requires to be decided by shareholders (for example the right of shareholders exercising 51% of the vote to remove a director), or are specifically reserved for approval by the shareholders.

4.3.8 A decision will need to be made as to whether the role of the board is to be:

- actively involved in the managerial decisions of the company; or
- operating in a more strategic/ supervisory role.

4.3.9 The outcome of this decision will influence the composition and structure of the board. If the board is to have an active executive role, then it will need to include individuals with the appropriate skills base. If however the board is to have a supervisory role, reviewing overall strategy and key decisions, it will consist mainly of representatives of the shareholders. An executive management committee (see below) will need to be established to whom the supervisory board will delegate conduct for the day to day running of NewCo.

4.3.10 As part of the negotiations for establishing NewCo, the partners will need to decide:

- the number of directors each shareholder can appoint to the board, together with any particular voting rights;
- whether the board can appoint additional directors;
- whether, as a matter of best practice, the board should contain independent non-executive directors;
- the matters to be decided by the board rather than delegated to the executive management;
- the frequency of board meetings;
- how board decisions are to be decided (including what represents a quorum);
- whether a director can appoint an alternate director to vote in his/her absence; and
- how the chairman's role is to be fulfilled.

4.3.11 Ideally, the chairman should be selected on the basis of executive managerial experience, knowledge of the business and associated market, leadership, and an appreciation of the shareholders' original motivations for starting the joint venture. The chairman will often be a shareholder's representative. This role is key, as he/she may have to resolve major disputes (e.g. the future direction of the company), and guide the management team through difficult times (poor results, loss of key staff, adverse financial markets).

Executive management committee

4.3.12 If the role of the board is to be supervisory, then it will be important to establish an executive management committee. The extent of the committee or an executive manager's authority will need to be determined and guidelines prepared. It is important to note that the board of directors will still have legal and fiduciary responsibility for the management of NewCo, even though authority has been delegated from the board to an individual or committee.

4.3.13 NewCo should be structured so that the party with the best skills to undertake a particular management function does so, irrespective of the shareholder's actual equity investment. For example, management could be vested in the private sector shareholder under a management services contract entered into with NewCo.

4.4 Directors' roles

4.4.1 The parties will need to agree the number of directors they nominate to the board of NewCo. As directors they will be required to attend and vote at board meetings and are legally responsible for the management of NewCo. The public sector will need to consider early on who they will ask to serve as their directors.

4.4.2 The primary obligation of a director is to NewCo, and they should act in the best interest of NewCo. As NewCo is owned by its shareholders, acting in its best interests will have to be assessed by reference to the shareholders and their long and short term interests. In the event that NewCo is insolvent, a director must also then consider the interest of creditors.

4.4.3 A director appointed by a shareholder may find they feel a conflict between acting in the interests of NewCo or in the interests of the shareholder in circumstances where such interests are not the same. This may be particularly strong where the director is also an employee of the shareholder who has nominated them. It is therefore very important for directors of NewCo to understand to whom they owe a duty and the exact nature of that duty. This is issue will need careful consideration for civil servants who are nominated as directors.

4.4.4 A director must:[39]

- comply with duties imposed on directors by statute (e.g. Companies Act 1985);
- carry out his/her duties with care and skill;
- act in good faith in the best interest of NewCo (fiduciary duties);
- act within the powers conferred on him/her by the Memorandum and Articles of Association;
- exercise independent judgement on behalf of NewCo (i.e. any restrictions entered into with a shareholder as to how to vote which would restrict a director's ability to vote in the best interests of NewCo would be a breach of duty);
- seek to avoid potential conflicts between NewCo and a director's interests or a duty owed to a third party; and
- comply with his/her duty of confidentiality to NewCo.

4.4.5 The constitutional documents and shareholders' agreement can help alleviate the concerns for a director appointed by a shareholder by:

- reserving certain matters (particularly those where conflicts are likely to arise) to be decided by the shareholders only and not by the board;
- imposing a restriction on a director from voting on any issue in which he/she has a conflicting interest;[40] or
- by expressly allowing a director to vote on a matter in which they have a conflicting interest, provided that the nature and extent of the director's interest has been fully declared to the board.

4.4.6 Directors should also be aware of their liabilities, both individually and for the body, and take out appropriate insurance (see Section 2.8).

[39] Further guidance can be found in the many texts produced to help directors, see, for example, that available from Companies House website: http://ws2.companieshouse.gov.uk/notes/gba1.html)

[40] This is the position at common law and is also set out in the standard Table A of the Articles of Association.

4.5 Corporate governance

4.5.1 It may be important to put in place corporate governance arrangements to provide protection when NewCo is at least partly funded by the public purse. These should be established to minimise the risk of conflict of interest and give reassurance to key public sector stakeholders over the propriety of the corporate arrangements. Examples of such arrangements include non-executive steering groups, advisory councils, audit committees, renumeration committees, etc. Reference to the Turnbull Report[41] should be made for further guidance on corporate governance.

4.6 Dividend policy

4.6.1 The shareholders will need to decide general policy for how any available profits of NewCo are to be distributed. The shareholders' agreement should include a provision setting out the principles of the dividend policy.

4.6.2 As dividend policies can be expressed in a number of different permutations, advice should normally be sought from legal and financial advisers. Examples include:

- a requirement to distribute no less than X % of the realised profits each financial year;
- a requirement to distribute all profits in excess of working capital requirements as specified in an agreed budget or business plan;
- a requirement that no profits are to be distributed until a certain event occurs; and
- a dividend 'holiday' while NewCo gets established.

4.6.3 In the specific case of distribution of surpluses from 50:50 joint ventures where the public sector partner is a Trading Fund, guidance has been issued by HM Treasury.[42]

4.7 Governing legal documents

Memorandum and Articles of Association

4.7.1 All companies incorporated in England and Wales have to have a Memorandum and Articles of Association. These are referred to as the constitutional documents of NewCo, and are lodged at Companies House. Standard forms can be provided which should be tailored to the requirements of the joint venture partners. Lawyers should be involved in drafting these documents.

[41] *Combined Code on Corporate Governance.* See www.icaew.co.uk/internalcontrol for further information.

[42] *Guide to the establishment and operation of Trading Funds* HM Treasury Central Accountancy Team, January 2001. See footnote 8.

4.7.2 The Memorandum describes the object of NewCo and gives NewCo its powers. The Articles of Association contain the procedural and regulatory requirements as prescribed by company law together with matters which are particular to the constitution of NewCo. The Articles can be amended from time to time by shareholders owning 75% of the voting rights.

Shareholders' agreement (or Joint Venture agreement)

4.7.3 A joint venture partner may express its intention to provide certain assets or funds to NewCo, but there will be no binding commitment to do so unless a shareholders' agreement is entered into. The shareholders' agreement is a contract and is governed by the ordinary rules of contract. Accordingly a shareholder (even a majority shareholder) cannot unilaterally amend the terms of the shareholders' agreement. Unlike the constitutional documents, the shareholder agreement is not a public document.

4.7.4 The public sector body and its advisers should prepare either a summary of the key terms of the shareholders' agreement or a draft of the shareholder agreement in any documents provided to potential partners. This is a key part of the public sector body's consideration of how it believes its desired outcomes can be achieved. In discussions/negotiations with potential partners, however, these draft documents may change and the public sector body should be flexible in its approach while ensuring it secures its requirements.

4.7.5 The types of commitments which the public sector body should seek from its joint venture partners should include:

- the initial subscriptions for equity of each joint venture party;
- an obligation of the parties to include any agreements to be entered into (e.g. any asset transfer agreement or licences);
- an agreement as to the business of NewCo;
- each party's intention for future funding commitments;
- procedures for managing NewCo and deadlock;
- dividend policy;
- exit provisions;
- any matters which are to be reserved for approval or veto by the shareholders;
- any non-compete provisions;
- obligations of confidentiality;
- obligations of transparency e.g access to charging information of private sector partner under secondment agreements or as required for public sector auditing purposes;
- the requirement to prepare a business plan each year; and
- the governing law and jurisdiction.

4.7.6 Care must be taken in drafting the shareholders' agreement. If the parties wish NewCo to be classified to the private sector, it is important that control of NewCo is not passed back to the public sector through excessive and restrictive veto rights or other obligations included in the shareholder agreement (see Section 2.4).

4.8 Business plan

4.8.1 A comprehensive business plan must be written with input from both parties at the outset of the formation of NewCo. The business plan will need to be updated on a regular basis once NewCo is established. The business plan may be arranged along the lines shown in Table 3.

Table 3: Example business plan headings

Summary of the proposal	• Short, succinct & complete
Background	• History • Understanding of business
Picture of the Business to be created	• What is the business? • How it will be constructed? • How will it be delivered? • Where will it be delivered? • What is the value chain? • What are the key processes? • What are the unique selling points?
The Market	• Description, size, growth • Customers • Competitors • Strategic strengths/competitive advantage • Delivery channels
Trading Plan	• Future view of balance sheet, P&L and cash flow (typically covering next 3-10 years) • Seasonality • Trading forecasts • Assumptions • Sensitivities • Required investor rates of return
Management and Organisation	• Organisational structure • Key managers • Staff levels and skills
Financing	• How much, when and how raised? • Security • Guarantees • Finnancing terms (e.g. cost, repayment schedule)
Business Strategy	• Direction of the business • Governance • Why will it succeed?
Risk	• What are the risks? • How could they impact? • How will they be managed and resolved? • What is the break-even strategy?

4.9 Minority shareholding

4.9.1 A minority shareholder will not have as great an influence in the decisions of NewCo as a majority shareholder. Although the law of England and Wales protects certain rights of a minority shareholder through statute or common law, it is generally considered that they do not go far enough in relation to joint venture arrangements where the minority shareholder may be contributing an important skill or resource to the venture.

4.9.2 In order to have a more influential "voice" in NewCo, additional protection is usually sought by a minority shareholder. The extent of such protection will depend upon the bargaining position of the joint venture partners and the actual percentage shareholding of the minority shareholder, e.g. a 40% shareholding should entitle the shareholder to greater influence than a 10% shareholding.

4.9.3 The types of additional protection that can be sought by shareholders, and of particular relevance to minority shareholders, are summarised in Table 4. Controls on sale of NewCo shares are an important way to secure protection, and are set out in Section 4.11.

Table 4: Forms of additional protection

Type of Protection	Comment
Board representation	A director on the board can ensure a shareholder is involved in the decisions of the board and is kept informed.
Approval and Veto Rights	A shareholder should seek a right of approval for certain issues where it holds a certain stipulated % of the shares or a veto right (either at board or shareholder level) in relation to key matters or major decisions which have a fundamental impact upon the business or operations of NewCo. Examples include matters which affect the capital structure of NewCo or could dilute a shareholder's equity stake. A key area of concern will be if contracts between NewCo and other major shareholders were entered into which are not at arm's length, thereby taking value out of NewCo.
Exit	Provisions which allow a shareholder to exit NewCo and guard against 'lock in', for example a 'put option' (see Table 5).
Dividend Policy	A stated dividend policy to prevent money being locked into NewCo (See Section 4.6).
Right to Information	Additional protection could be provided by a contractual provision in the shareholders' agreement for the right of access to certain information.
Claims against Majority Party	A shareholder should ensure that the right of NewCo to claim against the majority party for breach by that party under any contract with NewCo is not blocked by the ability of the majority shareholder to out-vote the minority shareholder.

4.9.4 A shareholder can include these protections either in the shareholders' agreement or in the Articles of Association. However, as the Articles of Association can be amended by shareholders with 75% of the voting rights, a minority shareholder may want to ensure required protection is included in the shareholders' agreement (which can only be amended with the agreement of all shareholders).

Box 6: Radiocommunications Agency joint venture: minority interest

When the Radiocommunications Agency decided that a joint venture company was the best vehicle for its proposed partnership with an IT supplier (see Box 5), it had to decide how such a joint venture company would be structured. Initially it specified that it would take a majority shareholding in the company.

Only after issuing this specification did the Agency's procurement team begin to consider the implications of the Agency having control over the joint venture company. The Agency commissioned a review of this question, which found that the fact that a publicly controlled joint venture company will be subject to normal Government accounting policies and requirements might deter potential private sector partners, as they may regard such requirements as "incompatible with the pursuit of commercial enterprises."

The Agency then sought legal advice on this question. Ultimately it concluded that sufficient rights to protect Government interests could be achieved contractually, which negated the need for the Agency to hold a majority of the shares. The Agency eventually took a 30% stake in the company.

Source: Partnerships UK, NAO

4.10 Deadlock

4.10.1 In a joint venture company, deadlock can arise at board level (for example where opposing positions are taken by an equal number of directors) or at shareholder level (where shareholders fail to agree those matters which have been reserved to them). The shareholders' agreement can provide for deadlock disputes to be escalated to senior individuals in the shareholders' parent organisations (for example to chief executives of the private sector company and the permanent secretary of a department).

4.10.2 However, some disputes may result in an intractable deadlock where there is a fundamental breakdown in management and the ability to continue with the joint venture. It may be useful at the outset to include in the shareholders' agreement mechanisms for avoiding deadlock (e.g. a Chairman's casting vote or referring disputes to an expert) and the consequences of an intractable deadlock. The rationale for this approach being that the shareholders will know the consequences of failing to resolve a deadlock and that this knowledge may help disputing parties to focus their minds on trying to resolve the disputes. Types of provisions for when a deadlock becomes intractable include:

- voluntary winding up of NewCo; or
- compulsory sale of shares by an aggrieved party (subject to any pre-emption rights); or
- put and call option (if a minority shareholder) (see Table 5).

4.10.3 Alternatively, the contractual documents may be silent as to the consequences of an intractable deadlock. The shareholders will then have to agree a procedure when it occurs rather than try to anticipate an appropriate procedure in advance.

4.11 Exit strategies

4.11.1 Exit provisions are needed to enable shareholders to realise their investment in NewCo (and thereby extract value), and to protect their investment if NewCo or other shareholders fail to perform in accordance with the agreed objectives.

4.11.2 Agreeing provisions for shareholders to exit from NewCo is likely to be one of the most difficult issues to resolve. This stems from the difficulty in determining the value of shares held in NewCo where they have no readily established market value. It is particularly important to ensure that the public sector body avoids the situation where it is forced to buy shares at an inflated value. This is a complex area, but typical mechanisms for calculating the value of shares include:

- net present value of future earnings;
- underlying asset value, e.g. calculated on the basis of depreciated replacement costs or net book value;
- break-up value; and
- the use of an expert valuer.

4.11.3 It will be important to draft appropriate provisions in the shareholders agreement (or Articles of Association) setting out the conditions for when and how shares in NewCo can be sold and NewCo wound up, taking account of the consequences of these actions. Before attempting to draft such provisions, the parties must be clear as to the underlying intention behind setting up NewCo, i.e. what are the objectives of the parties in setting up NewCo? How are these objectives to be realised? The following questions will need to be considered:

- To what extent can NewCo exist without the founders' involvement?
- Is NewCo being set up for a specific task or duration, so that when completed or reached NewCo will cease to operate?
- How are management deadlock or disputes to be resolved?
- In what situations would changes to the shareholders be required?
- Are there any situations where changes to the shareholders may not be permitted?

4.11.4 There are two basic scenarios for a shareholder to exit NewCo:

- *Voluntary* – either voluntary sale of the holder's shares in NewCo or where all the shareholders consent to winding up NewCo.
- *Compulsory* – events which compulsorily give rise to (a) a sale of a holder's shares or (b) winding up of NewCo.

4.11.5 A sale of shares will alter the ownership structure of NewCo, but NewCo and its business will continue. Therefore, where a shareholder sells its shares in NewCo and exits the shareholders agreement, parties will need to consider:

- what will happen to any assets or shared assets contributed to NewCo by the outgoing shareholder;
- how a price for the shares will be determined;
- what process will be used for approval of new shareholders;

- what will happen to any loans provided to NewCo by the outgoing shareholder;
- how to deal with any guarantees or indemnities provided by the outgoing shareholder;
- the extent to which the outgoing shareholder should be bound by obligations of confidentiality or restrictive covenants;
- whether any outgoing shareholder should be given a licence to use any intellectual property rights owned by NewCo;
- what will happen to any staff who have been seconded to NewCo from the outgoing shareholder;
- what will happen to any subsidiary contracts between the outgoing shareholder and NewCo.

4.11.6 In circumstances where NewCo is wound up (voluntarily or compulsorily), different considerations need to be addressed, particularly what will happen to the assets owned by NewCo. How the assets are to be distributed may depend upon the reason for the winding up. Under a default or deadlock scenario, the shareholder agreement may stipulate how assets are to be dealt with.

Voluntary sale of shares

4.11.7 The voluntary sale of shares is likely to be a main way of extracting value from NewCo (dividend payments and licensing fees/royalty payments being the other main ways). The strategy for selling the shares and realising value should therefore be considered in detail when forming NewCo.

4.11.8 Shares can be sold to other existing shareholders or third parties in a variety of ways (either a sale of a block of shares or all shares held by one party), including trade sale or the flotation of all or part of the company (see Section 6.1).

4.11.9 As NewCo has been set up by agreement of at least two parties for a specific purpose, it is important to have a degree of control over the ability of the parties to sell their shares. It is usual to include in the Articles of Association (or shareholders' agreement) specific principles that may prevent a party from selling its shares or may restrict a party's ability to sell its shares to certain third parties.

4.11.10 Table 5 describes a number of different mechanisms which may be adopted to control how and when a shareholders sells its shares in NewCo.

Table 5: Mechanisms related to the sale of NewCo shares

Mechanism	Explanation	Comments
Lock in period	Prohibition on a party from selling its shares for a specified period.	To ensure that an important partner stays involved and to incentivise the party to achieve the objectives of NewCo.
Consent of other shareholders not to be unreasonably withheld	Prohibition on a party from selling its shares without the consent of all other shareholders not to be unreasonably withheld.	Where the participation of the private sector party is considered critical for NewCo, this could be a compromise to a lock-in period. It is important to question whether a party who is refused consent to sell will still be willing to contribute to NewCo, or whether they will feel aggrieved; the mechanism is therefore sometimes linked to a winding up provision of NewCo if the sale of shares is refused.
Approval of Board	Any transfer to be subject to approval of NewCo Board.	This mechanism may favour a sale by a majority shareholder who has greater board representation than a minority shareholder.
Put and call options	Where a party may have an option to require the other party to buy or sell their shares. The option for a compulsory transfer could be exercisable at will or on a trigger event depending upon how the shareholders have structured the joint venture (see Table 6).	This option can enable a party to require the other party to sell or buy its shares. As these provisions may force an unwilling buyer/seller, they may not be appropriate for a joint venture. They may be a useful mechanism for minority shareholders to prevent a lock in.
Pre-emption rights	Any shares for sale must first be offered to the other shareholders in accordance with agreed procedures and a share valuation mechanism to prevent opportunistic pricing by the exiting party.	This standard provision is a useful mechanism for the remaining party to consolidate control (subject to being able to raise the cash for the shares and any classification consequences, see Section 2.4).
Intra-group transfers	Allows members to transfer shares to other companies within a group of companies.	A fairly standard mechanism. It is important to define carefully the parties who are in the “group” e.g. is it a “wholly owned subsidiary” or any subsidiary.
Piggy back	Variation to pre-emption rights mechanism which allows a party to sell its shares to a third party provided that if the remaining shareholders wish, the third party buyer also buys the entire shareholding of the other shareholders.	This is a useful mechanism for a minority shareholder who may wish to sell out where its partner has found a buyer. The effect of this clause is that it is the sale of the entire NewCo to a third party. Consideration will need to be given to the status of any subsidiary contracts.
Drag along	Where a party (generally a majority shareholder) is permitted to sell its shares to a third party it can also force its joint venture partners to sell their shares to the same third party.	The rationale for this mechanism is that a business is far more saleable where it is a sale in its entirety or of a majority of shares sufficient to give buyer effective control. The effect of this provision is that it is the sale of the entire NewCo to a third party.

Table 5: Mechanisms related to the sale of NewCo shares (continued)

Mechanism	Explanation	Comments
Tag along	A minority shareholder can force a sale of its shares to a third party buyer of a majority shareholding at the same price.	This mechanism provides an exit route for a minority shareholder so that it does not find itself in a joint venture with a completely different joint venture partner. Tag along and drag along provisions usually go together. They need to be treated with caution in joint ventures focused on long-term partnership and not simply about investment and realisation of a return.
"Russian roulette"	Halfway between a voluntary and compulsory exit, this mechanism allows a party wishing to exit a joint venture at any time to offer its shares for sale to the other party. If the other party rejects the offer to buy, it must offer its own shareholding to the original seller upon the same terms.	This mechanism can only be used where the parties are on an equal footing. It cannot work where one party is weaker in its ability to buy shares (e.g. because of funding constraints), as the party forcing the issue may take advantage of this to force a sale of shares by the other party. Given that this method makes it difficult to prove value for money, it does not seem appropriate to a public-private joint venture.
"Texas shoot out"	A variant of Russian roulette where one party applies to buy the other party's shares. If this offer to buy is rejected, a counter offer for the purchase of the "buyers" shares must be given at a higher offer. Then the parties may go to sealed bids with a sale to the highest bidder.	This is more akin to form of compulsory transfer. As with Russian roulette, a mechanism where the price paid for the shares is not open to scrutiny is unlikely to be appropriate to a public-private joint venture.

Box 7: The Ordnance Survey joint venture: PointX

Ordnance Survey (OS) has formed a joint venture Company, PointX Ltd, with two private sector partners to develop and commercialise a 'points of interest' (POI) database. This database will bring together both business information and topographic features source from OS' existing large- and small-scale products. PointX plans to license in other directories and information over time, depending on customer needs.

Using OS' unique position referencing system, PointX will integrate data so as to provide geographically-based consumer and business services such as locating the nearest bank or petrol station or planning delivery routes via existing landmarks.

The initial share split between the three partners is 40 (OS):30:30. The business case envisaged that it would take a few years to realise any profits, and the agreed value extraction route is to look for an initial public offering (IPO) in several years time. The partners were chosen specifically to undertake and organise the work over this period, and so with this in mind, a number of measures related to exit were negotiated and included in the shareholders' agreement:

1. Lock in period: all parties agreed a lock-in period to the joint venture company; and
2. Tag along / drag along provision. If a potential buyer wishes to buy more than a certain percentage of the company's shares, it must also offer to buy at the same price the remaining shares (tag along). After an agreed time period, a potential buyer of all the company's shares who is acceptable to the shareholders holding more than an agreed percentage of the shares, has a right compulsorily to purchase the non-accepting shareholders' shares, subject to the non-accepting shareholders having the prior right to buy the shares being offered to the potential buyer (drag along).

These measures, when taken together with other share transfer provisions, provided confidence to each of the parties that they were committed to the same short and medium term strategy.

Source: Partnerships UK, PointX Ltd

Voluntary winding up

4.11.11 In some cases shareholders may all agree to exit the joint venture by winding up NewCo (shareholders' voluntary winding up). This may occur where for example the objectives of NewCo have been achieved or the underlying rationale for setting up NewCo no longer exists.

4.11.12 The shareholders' agreement may include detailed provisions stipulating a particular procedure to apply to the disposal or break up of NewCo's assets (for example a compulsory auction of its assets) together with any ongoing provisions as to confidentiality or restrictive covenants which should continue following the winding up of the company.

Compulsory sale of shares or winding up

4.11.13 The shareholders need to agree whether there are circumstances or default events which may trigger:

- the right of one party to compel the other party (usually a defaulting party though not always) to sell its shares; or
- NewCo to be wound up.

4.11.14 Table 6 sets out a few examples of the type of trigger events which the shareholders may wish to consider. It is not intended to be a complete list.

4.11.15 In addition to a specified default event, it will always be open to a shareholder to apply for a court order compelling the winding up of NewCo on the grounds that this would be "just and equitable" under the terms of the Insolvency Act 1986.

Table 6: Trigger events

Event	Consequence	Comments
Material default by one party	Right to compel the defaulting party to offer its shares for sale (usually to the non-defaulting party under pre-emption rights).	Default events include a material breach of the shareholders' agreement (usually a breach which is incapable of remedy) or possibly of any other agreement (such as subsidiary contracts) or breach by the private sector party to inject capital into NewCo.
Insolvency of a joint venture partner	Right to purchase insolvent party's shares through a "call option."	This default event will only apply to a private sector party. The definition of "insolvency" should be carefully drafted and may need to include parent companies. The mechanism for valuing the share price will also need to be considered.
Change of control of a joint venture partner	Option to require the party which is subject to a change of control to sell its shares or buy the shares of the other party.	This default event will normally only apply to a private sector party. It needs a sensible definition of "change of control". This mechanism allows the party who has not changed control to determine whether or not to continue the joint venture, and if not whether to carry on the business on its own (by buying the other party's shares) or exiting (by selling its shares).
End of licence or end of purpose	Right to compel NewCo's winding up.	Useful where a company has been set up for a specific purpose which has ended or where a regulatory licence has been revoked.
Invalid transfer of shares	Provisions which enable the transfer not to be effective and to provide for compulsory purchase of shares.	This is important to prevent a party from benefiting from acting outside the provisions set out in the shareholders' agreement or Articles of Association in relation to transferring shares.

5 ASSETS

Each joint venture partner will contribute certain assets and resources to the joint venture company. This section outlines some general considerations on assets contributed by the public sector, and provides more details on:

- Intellectual Property provisions and considerations for when the public sector contributes Intellectual Property to the joint venture company.
- Staffing and transfers of public sector staff to the joint venture company.

5.1 General

5.1.1 The assets which the joint venture partners could contribute to NewCo include staff, buildings; equipment or land; finance; or intangible assets, for example intellectual property rights. These assets will form an important part of the structure of the business and should be provided under separate contracts (referred to in this guidance as subsidiary contracts). The public sector body will normally contribute assets in return for equity in NewCo, and it is therefore important that they are properly valued. Consideration should also be given to how the assets should be dealt with on exit from or termination of NewCo.

5.1.2 *Selling Government Services into Wider Markets: Policy and Guidance Note* makes it clear that public sector bodies will not normally vest a tangible asset such as equipment to NewCo (although such assets may be leased to NewCo on appropriate terms). In the exceptional circumstances where a tangible asset is vested in NewCo, the public sector body should seek to ensure that in the event of disposal of the asset, an appropriate share (which will depend on how the asset is valued on being vested into NewCo) of the proceeds accrues to the Exchequer.

5.2 Intellectual Property Rights

Introduction

5.2.1 Given the enormous variation between joint venture agreements as to objectives, form and subject matter, it is very difficult to generalise as to their intellectual property provisions. As Intellectual Property Rights (IPRs) could outlive the joint venture, the intellectual property provisions should be carefully tailored to the objectives and commercial specifics of the transaction. Competition law and state aid aspects will need to be considered (Sections 2.6 and 2.7).

5.2.2 This section gives a brief overview of the types of issues that a public sector body should consider when it is intending to contribute IPR to NewCo, for example where NewCo has been established to realise the potential commercial application of some technology or invention created in the public sector.

What are Intellectual Property Rights?

5.2.3 Intellectual Property Rights are limited monopoly rights that exist for certain works. The key types of IPRs are:

- Patents – available for inventions relating to most industrially applicable processes and products. A patent must be registered before the invention is publicly disclosed, indeed prior disclosure or publication prejudices the patent position.

- Copyright – a property right which protects literary, dramatic, musical or artistic works, sound recordings, films, broadcasts, cable programmes and typographical arrangements from being copied. The subject matter must be original and recorded in some way. There is no requirement for the copyright to be registered.
- Designs – the shape, configuration, pattern or ornament applied to an article may be protected by registering the design at the Designs Registry or, if not registrable, by virtue of the inherent design right.
- Trade marks – brands such as words, logos, colours, shapes, sounds and even smells which can be graphically recorded may be registered as trade marks to protect the way a supplier represents his goods and services. More subtle forms of branding such as the look and feel or general "get up" of a product or its packaging can be protected by the law of passing off which does not require the packaging or product to be registered.
- Database rights – the right to prevent extraction or re-use of the whole or a substantial part of the data contained in a database in the production of which a significant amount of time and/ or money has been invested.

5.2.4 Not all intellectual or intangible assets can be protected by IPRs. Know-how and expertise are often an important asset within the public sector, but which cannot be protected directly with IPRs. Contributing know-how to a joint venture is potentially risky as there is no legal mechanism to prevent the know-how being leaked to the joint venture company partner and re-used. The public sector should know the value of any know-how it contributes, and consider the risks and consequences of losing it to the private sector partner.

Identification

5.2.5 The first step will involve identifying the existing IPRs that the public sector body is intending to contribute to NewCo. This could involve preparing a list of the patents that NewCo will need the rights to or a list of key information or reports which are protected by copyright, or know-how/database rights that will be required.

Ownership issues

5.2.6 The next step will involve establishing exactly what rights the public sector body has in the existing IP. For example, does the inventor of the patent have certain rights over the patent? If so, how are these to be dealt with? Could the inventor be given an equity stake in NewCo? Could the copyright be Crown Copyright, in which case the appropriate consents will need to be obtained from HMSO? All these issues will need to be tackled very early on in the process of setting up a joint venture company, preferably when preparing the outline business case.

5.2.7 If the public sector body owns the IPR, it will have the right either to license the IPRs to NewCo or assign ownership of the IPRs to NewCo.

5.2.8 If the public sector body is a licensee and the IPRs are owned by a third party, it will need to establish exactly what rights it has to make the IPRs available to NewCo. This will depend upon the terms of its licence, which will need to be checked to determine whether the public sector body can assign the licence to NewCo or grant a sub-licence to NewCo. If the licence prohibits either of these options, the public sector body will need to decide its next course of action, which may be to try and re-negotiate the terms of the licence with the IPR owner.

Methods of contributing IPR to NewCo

5.2.9 As discussed above there are two methods:

- a licence agreement on arm's length terms (as it may well continue beyond the owner's equity interest in NewCo); or
- an assignment of the ownership of the IPR to NewCo.

5.2.10 The most appropriate method will depend upon a number of key issues, including identifying the extent to which the public sector body needs or intends to continue to use, develop and further exploit the existing IPR independently of NewCo. However, the private sector may not always be keen to invest unless ownership of the IPR is assigned to NewCo.

5.2.11 Table 7 identifies possible differences between a licence and an assignment. In practice, most desired arrangements can be achieved through either licensing or assigning an IPR, by the use of specific clauses in the respective agreements. For example, a licence can be royalty-free, in perpetuity and responsibility for protecting the IPR can be allocated to NewCo; an assignment, on the other hand, can have provisions for continuing payments and ownership of the IPR can transfer back as a result of defined trigger events. Nevertheless, Table 7 provides a guide as to the most appropriate route to follow.

Table 7: Possible differences between licences and assignments

	Licence	**Assignment**
Ownership of existing IPR	Remains with the licensor	Is transferred to NewCo: useful where NewCo requires control of IPR, will a licence back to original owner be required?
Payment	Licence fee or royalty stream (potentially convertible into equity) will need to be on arm's length basis and will reflect the nature of the joint venture	One-off lump sum or in exchange for an equity stake in NewCo
Protections	Cost of protecting and enforcing the IP generally remains with the licensor/ owner (although for an exclusive licence these costs could be assigned to the licensee)	Cost of protecting and enforcing the IP transferred to NewCo
Termination	Termination provisions giving the licensor a right to terminate the licence usually included	Rights may or may not revert back to the original contributing party depending upon the terms of the shareholder agreement
Restrictions/control	Licence can include certain restrictions in order for the licensor to control use of existing IP	As owner of the existing IP, NewCo will have the rights of an owner
Warranties	NewCo should seek warranties in relation to ownership of the IPRs which are the subject of the licence	NewCo should seek warranties in relation to ownership of IPRs and transfer IPR to NewCo
Duration	Limited	May be unlimited

5.2.12 The types of provisions which will need to be covered in a licence include:

- whether the licence is to be sole, exclusive or non-exclusive (with due regard to competition law in this regard see Section 6.2);
- the duration of the licence;
- whether the licence is restricted to certain fields of use of the technology;
- whether the licence is restricted to particular geographical territory;
- the payment mechanism: regular fee, royalty, lump sum;
- how the licensor is to protect and enforce against any third party infringement of its IPR;
- to what extent NewCo can modify and adapt the IPR, and who will own any IPR in any such modifications or adaptations; and
- the circumstances upon which the licensor can terminate the licence – how this will impact upon the ability of NewCo to carry on its activities and the effect upon the value of any shares in NewCo.

Calculating the value of the IPR contribution

5.2.13 This is a very complicated area, and appropriate advisers may need to be involved to (a) value, where feasible, the public sector body's IPR contribution, and where not, to give as good an idea as possible of the worth of the IPR; or (b) structure NewCo to ensure that the public sector obtains the appropriate value for its IPR contribution.

Table 8: Pros and cons of IPR valuation methods

	The Cost Approach	The Market Approach	The Net Present Value (NPV) or Income Approach
Method of valuation	Assumes that there is a correlation between commercial value of intellectual property and the cost of its research and development (R&D), taking into account the costs of R&D, promotion, and depreciation/appreciation	Arrives at a market price for the intellectual property in question, based on comparable IPR currently or recently transferred in the open market	Estimates the economic benefit that might derive from the IP during the protection period, less the input costs and other quantifiable calculated risks
Pros	Very simple to calculate	In theory, relatively easy to calculate provided that a suitable comparator exists	Closest method to reflecting true potential of certain IPRs, notably patents Can adapt to the amount of protection offered by different forms of IPR protection
Cons	The commercial value of IPR does not necessarily correlate with the input costs. For example, a trade mark may cost almost nothing to create but have huge consumer recognition and be extremely valuable.	There is often no suitable comparator available because of the unique nature of IPR. Further, details of valuations used are very rarely made public.	Complex calculation Requires considerable background data Produces subjective valuation
Likely to be suitable for	Copyright, design right (registered or unregistered)	Trade marks (because generally more comparators), copyright (but only if a reasonable comparable is available)	Patents (most suitable approach), trade marks

5.2.14 Three common methods for the valuation of IPRs are the Cost Approach, the Market Approach and the Net Present Value or Income Approach. Table 8 sets out the pros and cons of the different methods, though they are not mutually exclusive. Table 8 also suggests which method might be more appropriate for different types of intellectual property right, although this will depend on the particular case and on the cost considerations of undertaking valuations.

Box 8: Public-private joint venture companies: IPR licensing

As described in Box 4, CEFAS has now taken equity stakes in two joint venture companies, set up under the Wider Markets Initiative. For both its joint venture companies, CEFAS has licensed the relevant technology (with fixed royalty and shares on revenue), with a further option to buy shares. It did this in order to lower its risk profile on entering the joint venture's equity.

The Babraham Institute, a public sector research establishment, has set up a joint venture company through its wholly-owned trading arm Babraham Bioscience Technologies Ltd. The company, called Discerna Ltd, is 50:50 owned with KS Biomedix plc, and brings together Babraham's advanced ribosome display technology and KS Biomedix's proprietary therapeutic targets. Under the terms of the deal, KS Biomedix will provide funding to the joint venture for two years, and certain therapeutic targets. Babraham has assigned to Discerna exclusive worldwide IP rights to develop the ribosome display technology, with repatriation rights for specific circumstances; any new IP generated by Babraham related to or dependent on the ribosome technology will also be assigned to Discerna. Discerna will be able to license its IPR to other collaborators in the future.

Source: Partnerships UK, CEFAS, Babraham Institute

Procedures for dealing with future IPRs

5.2.15 The public sector body will need to clarify in the shareholder agreement and/or IPR agreements the position in relation to new IPRs created in the future by either NewCo, the public sector body or any of the joint venture partners.

5.2.16 The options for future IPRs created by NewCo are set out in Table 9.

Table 9: Options for ownership of IPR created by NewCo

Options	Comment
Owned by NewCo	Does the public sector body or any other shareholder want a right to use IPRs in particular sectors? What will be the terms of the license to use? If not possible to agree terms now, should public sector/other shareholders have an option to call for a license? What is to happen to the IPR/licence to use on any winding up of NewCo?
Owned jointly by the shareholders	In the UK IPR can be jointly owned. This is not the case in all jurisdictions. Unless joint owners have set out express rights in relation to the IPR, a joint owner can only use and exploit the IPR in the course of its own business. There is no right to exploit the IPR through third parties. If joint ownership is chosen, suitable cross licensing provisions will need to be drafted between all the shareholders to deal with exploitation rights and maintaining the IPRs. This option if potentially complicated and should be avoided if possible.
Owned by one of the shareholders	NewCo will need a licence to use the IPRs Will any of the other shareholders be able to use the IPRs? If so under what terms? What will be the position if the owning shareholder leaves the joint venture?

5.2.17 If a shareholder creates IPRs which are relevant to NewCo, consideration will be needed on how these IPRs will be made available to NewCo, whether the IPRs should be licensed to NewCo and if so on what terms, or whether NewCo should have an option to acquire the rights. This may vary depending on whether the new IPR is created on the back of the existing IPR or not.

Procedures to deal with exit of a shareholder

5.2.18 At the outset a strategy will need to be adopted to deal with IPRs when a shareholder exits the joint venture (both for IPRs licensed into NewCo by a shareholder or licensed out of NewCo to a shareholder – see also Section 4.11). The strategy should differ depending upon whether the shareholder is in default or not. Table 10 provides a few examples.

Table 10: Examples of Termination Events

Termination Event	Consequences of Event	Comment
Default by or insolvency of a shareholder	All licences to the defaulter cease, as does its right to any further licences provided in the shareholder agreement All licences in favour of the non-defaulting party (including from the defaulter) continue, as does their right to further licences	The non-defaulting party should not be penalised because of the default of the other party. Where licences cease, then non-defaulting party should ensure that all materials and information relating to the licence in the possession or control of the defaulting party is returned and/ or destroyed.
Termination without default e.g. permitted change of control of a joint venture party, voluntary withdrawal on permitted sale of shares	All existing licences continue The right to any further licences ceases	The withdrawing party does not get the benefit of any future IPRs, where it has no equity at risk.

5.3 Staff Issues

General

5.3.1 The joint venture partners will need to determine how NewCo is to be staffed and by whom. Often it is important to the success of the joint venture business that particular employees of one or other of the joint venture partners, who have an in-depth knowledge of the asset or a specific expertise, continue to provide this knowledge and expertise to NewCo. Where particular skills are needed which cannot be provided by the parties, NewCo will need to recruit from the market place. Additionally, NewCo will need to take out appropriate insurance cover for its key employees.

Transferring skills or employees to NewCo

5.3.2 There are several methods available, depending upon the particular circumstances. These include:

- resignation from current employer and re-employment by NewCo;
- secondment to NewCo;
- automatic transfer under the Transfer of Undertaking (Protection of Employment) Regulations 1981 (TUPE);
- 'novation' (a form of transfer) of an employee's existing contract of employment to NewCo; and
- others, such as the provision of the required skills under a consultancy contract or by staff taking unpaid leave from the parent organisation.

5.3.3 Where it is identified that certain employees should work for NewCo, there are specific considerations to be made. These include:

- Are the right staff transferring?
- Do staff want to transfer?
- Are there incentives for staff to transfer?
- What is the most appropriate route?
- Could TUPE apply if an existing undertaking or function is to be transferred into NewCo?
- What happens to the pensions of the staff transferring?

Resignation from the current employer and re-employment by NewCo

5.3.4 Where NewCo is carrying on a completely new business distinct from the business of either party – so no existing business operation is to be transferred into NewCo from either party – then it is unlikely that TUPE will apply. In this case, employees will not automatically transfer to NewCo and can only transfer into NewCo where they are willing to do so.

5.3.5 Such a voluntary transfer will involve:

- termination of an employee's existing employment contract with their current employer; and
- an employee entering into new contract with their new employer, NewCo which will mean: in general no continuation of employment; potential for new terms and conditions of employment to apply to the transferring employee; liability by NewCo for the actions of its employee.

5.3.6 The transfer must be by "mutual consent". A former employer should express acceptance from the employee that it has no claims against its former employer regarding the transfer to NewCo and acceptance of the job offer.

5.3.7 Certain statutory protections[43] may apply to an employee who transfers to NewCo, where NewCo is an "associated employer" to the current employer (i.e. if the current employer has "control" over NewCo). Hence, these protections can apply to transfers from the majority shareholder to NewCo.

5.3.8 The advantage of this route for NewCo is that new employees can enter into contracts of employment specifically tailored to the needs of NewCo (including where appropriate employee share options and other staff incentives – see below), with all staff being employed upon the same terms.

5.3.9 Where employees are to transfer from the public sector to NewCo in these circumstances, where TUPE regulations do not apply, the public sector should comply with government policy[44] which states that: "in circumstances where TUPE does not apply in strict legal terms ... the principles of TUPE should be followed (where possible using legislation to effect the transfer) and the staff involved should be treated no less favourably than had the Regulations applied."

Secondment

5.3.10 Under a secondment arrangement, an employee will continue to be employed by their current employer, but is seconded under the terms of a secondment agreement to NewCo. This is a useful option when setting up a joint venture company, particularly in the area of science and technology, where the continuing close involvement of the inventor/developer may be important. The secondment of an employee to NewCo provides access to key staff for a defined period which, when concluded, allows the employee to return to their original employer.

5.3.11 A number of issues will need to be addressed when setting up a secondment arrangement. Some key points are:

- The terms of the secondment agreement (for example remuneration for the employee – this should usually be at cost, NewCo should not pay a mark up for secondees).
- Liability for the actions of the employee whilst under the instructions and control of NewCo. An employer could seek protections in the shareholder agreement by way of an indemnity from NewCo.
- Ownership of any intellectual property rights created by the secondee whilst working for NewCo. The usual position is for the intellectual property rights created by an employee to vest in the employer. This may not be appropriate in the context of some NewCos, in which case express provisions should be included in the secondment agreement.
- Confidentiality obligations in the secondment agreement to protect the confidentiality of NewCo and the employer.

[43] Employment Rights Act 1996

[44] *Staff Transfers in the Public Sector Statement of Practice,* Cabinet Office. January 2000.

Transfer of Undertakings (Protection of Employees) Regulations 1981

5.3.12 If in forming NewCo an existing business or part of a business is to be transferred into NewCo from one or both of the joint venture partners, legal advice will need to be sought to establish whether the transfer falls within the definition of an economic entity to which the TUPE Regulations apply.

5.3.13 The TUPE Regulations implement the 1977 EC Acquired Rights Directive as amended.[45] In broad terms, where an identifiable and severable part of existing business operation is transferred, an employee who works in that business operation will automatically transfer to the new employer unless:

- the employee is redeployed elsewhere in the employee's business; or
- the employee exercises their right to object to the transfer (in which case their employment is terminated and unless there has been a breach of the TUPE Regulations, no severance pay will be available).

5.3.14 For a transferring employee:

- No consent to the transfer is required to be given by the employee.
- TUPE protects the employee's existing terms and conditions of employment (including union recognition) except that rights and benefits in relation to occupational pensions do not transfer.[46]
- Employment with the new employer is treated as continuous from the date of the employee's start with the first employer.
- Terms and conditions cannot be changed, even with the agreement of the transferring employee, where the operative reason for the change is the transfer. Any such change will be void.
- Both parties will need to comply with their obligations relating to informing and consulting the affected staff.

5.3.15 If NewCo seeks or forces an amendment to employees' existing contract terms, employees will generally have the right to treat themselves as having been constructively dismissed, with consequent claims for wrongful and (if they have worked for the requisite qualifying period) unfair dismissal.

5.3.16 If NewCo wished to try and harmonise the terms of employment of its staff through negotiations (as the terms will be different where staff include new recruits and TUPE transfers) this is only possible in respect of the TUPE transfer employees where the cause is attributed to other reasons and not the transfer.

5.3.17 It is always prudent to ensure that the appropriate warranties and indemnities are negotiated between the joint venture partners and NewCo. Advice should be sought so that the public sector body is adequately protected both as a former employer and as a shareholder in NewCo.

[45] Revisions were adopted by the EU in June 1998, but have not yet been implemented into UK law.
[46] This situation is currently under review.

Novation of an employee's existing contract of employment to NewCo

5.3.18 An alternative option, if all parties agree, may be a novation (a form of transfer or assignment) of an existing contract of employment to NewCo, in which case there would be no "dismissal" of the employee. It would also be open for the parties to negotiate certain changes to the contract of employment. For example, the parties could include an express provision that an employee's continuity of employment for statutory purposes will be preserved.

Incentives for staff

5.3.19 It is important when considering a joint venture company to identify any members of staff who are key to the project and to ascertain if they are willing to transfer from the public sector. Incentives can be offered to encourage staff to transfer. For public sector research establishments, guidance on staff incentives are outlined in the *Good Practice guide* published by the Office of Science and Technology.[47]

5.3.20 An important incentive often comes in the form of an equity stake in the new entity for key members of staff. The rules governing civil servants have recently been clarified in order to facilitate civil servants taking equity shares in companies where appropriate,[48] and in accordance with the specific guidance.[49] This can be particularly relevant when there is a transfer of technology in which staff have been centrally involved.

Pensions

5.3.21 Pensions are often an important element in the overall remuneration of staff in the public sector, and the public sector occupational pension schemes offer a high quality of benefits. Not all private sector pension schemes are commensurate with the public service schemes, and where good quality pension schemes are offered, they typically differ in major respects, for example:

- age of normal retirement;
- rate of accrual of pension entitlements;
- provision of a lump sum on retirement; and
- degree of indexation of pensions increases.

[47] *Good Practice for Public Sector Research Establishments on Staff Incentives and the Management of Conflicts of Interest,* Office of Science and Technology. Available at the DTI website: http://www.dti.gov.uk/ost/aboutost/psre.htm

[48] See paragraph 4.3.8 of *the Civil Service Management Code* available from the Cabinet Office website http://www.cabinet-office.gov.uk/civilservice/managementcode/csmc.pdf.

[49] PIN 43 *Information note for personnel managers. Participation of civil servants in the commercialisation of public sector research.* Available as Annex A to *The Government Response to the Baker Report,* Office of Science and Technology and HM Treasury, 1999. Available at the HM Treasury website: http://www.hm-treasury.gov.uk/docs/1999/baker.html.

5.3.22 Occupational pensions are not currently covered by the TUPE Regulations. However, where public sector staff are transferred compulsorily to another employer there is guidance to protect them from material detriment to their pension terms, and it is important for pensions protection to be addressed in these cases from an early stage in the process.

5.3.23 Full guidance on pensions in staff transfers is given in several documents.[50]

Confidentiality

5.3.24 As there are likely to be close links between each joint venture partner and the employees of NewCo, employment contracts will need to include appropriate confidentiality provisions to prevent unauthorised disclosure of information belonging to either NewCo or the joint venture partners. In addition, the public sector founder may wish to include a positive obligation on NewCo in the shareholders agreement to put in place appropriate confidentiality arrangements.

Directors

5.3.25 The directors of NewCo may be officials of NewCo, for example the Chief Executive Officer, or employees of each of the shareholders nominated by the respective shareholders to the board. The role and duties of directors of NewCo need to be understood by the individual taking up the directorship (see Section 4.4).

[50] *Staff Transfers in the Public Sector – Statement of Practice,* available at the Cabinet Office website: http://www.cabinet-office.gov.uk/civilservice/2000/tupe/stafftransfers.pdf. *Assessment of Broad Comparability of Pension Rights, Statement of Practice by the Government Actuary,* and *Staff Transfers From Central Government: A Fair Deal for Staff Pensions. Guidance to Departments and Agencies,* both available from http://www.gad.gov.uk/adiv/adiv2.htm.

6 FINANCIAL AND COMMERCIAL ISSUES

The joint venture company will need to be properly funded and financially viable. This section:

- Considers options for funding NewCo.
- Summarises policy and legal constraints on NewCo's commercial conduct and particularly how it charges for its products and services.
- Lists a number of tax issues which can be relevant to the formation and operation of NewCo.
- Outlines the need to check whether NewCo's activities will be subject to EC public procurement rules.

6.1 Funding

6.1.1 In order to operate, and in particular to expand and reach the various stages of a commercial operation, NewCo will require sufficient funds. Under the Wider Markets Initiative, the expectation is that these funds should normally come from the private sector. The timing, amount and origin of these funds will depend on the operation, nature and structure of NewCo.

6.1.2 This is an area where professional advice should normally be sought and this section only provides a brief overview. The value for money aspect is key and can be considered in terms of providing a reasonable return for a given investment, judging the risks associated with a given capitalisation structure.

6.1.3 Funds for NewCo can be raised in a number of ways, at both initial funding stage and subsequent rounds of funding. These include:

- issue of shares (equity);
- debt raising; and
- grants.

6.1.4 Providers of funding differ in the risk/reward profiles that they are seeking from the investment. Those buying shares are prepared to take higher risks in the expectation of higher returns on their investment. Banks, on the other hand, will not provide debt unless the risks are low, but seek a lower return. Grants providers do not require any financial returns, but grants are only available for certain activities and usually have conditions attached.

6.1.5 NewCo can raise funding by any combination of these three means, both when it is formed and in subsequent fund raising. However, at formation the risks are inherently greater as NewCo has no track record, and so funding at this stage will typically have to come from NewCo's founders.

Issue of shares (equity)

6.1.6 This is the selling of shares in order to raise funds. These shares can be of many classes (different types with different rights), and can include voting and non-voting shares (see Section 4.2). The principal sources of equity funds are:

- founding partners;
- venture capitalists/private equity funds, including through trade sales; and
- the capital markets through flotation and a public listing.

6.1.7 Typically, equity funding will be provided by the founding partners in the early stages of NewCo's existence (such as the initial funding round). If NewCo is successful and requires substantial further equity funding, then the involvement of venture capitalists or private equity funds may be required. Only if NewCo's cash requirements are very large is it likely that equity funding will be sourced through the capital markets. Some of the implications of these different routes are brought out below.

6.1.8 When additional shares are issued, it is important to consider the implications, particularly with respect to dilution of the public sector interest (see also Section 4.11). This issue can be managed by issuing different classes of shares in the new issue, for example a dividend only, non-voting class of share. However, typically, such investors will seek some degree of control to match their investment.

Founding partners as a source of equity funding

6.1.9 The founding partners are often the preferred source of equity funding, as they already understand the business and are committed to it. However, they may not have sufficient funds available, or may be unwilling to increase their exposure to the risks of one particular venture.

6.1.10 When NewCo is formed, the private sector partner will typically commit to provide funding in return for equity shares. Funding commitments may be in the form of partly paid shares, or there may be a commitment to subscribe for further shares embodied in the shareholders agreement, or a commitment to provide shareholder loans. It is important to ensure that such funding commitments are sufficient for NewCo's initial needs and that the private sector partner is credit worthy.

Box 9: MRC companies: dilution of shareholding

RiboTargets Ltd was established in July 1997 as a spin-out company from the Medical Research Council's (MRC) Laboratory of Molecular Biology (LMB) in Cambridge. The company raised £7m from four investors (Apax Partners, Advent International, 3i, and Kargoe). In return for the MRC's Intellectual Property, know-how and limited use of specified facilities at LMB, the MRC took a 10% shareholding in RiboTargets and a seat on the Board of Directors.

In a subsequent round of financing some 36 months later, £6m was raised from the same set of investors plus Rendex, NIB, and Quester. The MRC, who because of their charter were unable to invest at subsequent rounds and were consequently diluted by approximately 50%. After this second financing and as a result of the MRC's continued support for the company and input at the Board level, the MRC director was asked to continue on the board, which he did for a further 6 months.

In 2001 the company is expecting to raise a third round of finance to underpin a significant expansion in its development plans and research programmes. The MRC's shareholding will be further diluted; however the net worth of these shares continues to increase as the company's market capital and share price continues to climb. This long-term strategy has served MRC well.

Another example is the MRC's holding in Cambridge Antibody Technology (CAT). In the early 1990s MRC held founding equity in CAT in return for defined IP. In subsequent funding rounds the MRC holding was diluted; however MRC later invested additional technology in CAT in return for further shares. Since the flotation of the company, MRC has sold parts of its shareholding at different times to raise around £10m. In this example the public sector body was able to invest further technology at a later stage in the company's development and benefit by reducing the dilution effect on its shareholding.

Source: Partnerships UK, Medical Research Council, RiboTargets Ltd

Venture capital/ private equity funds

6.1.11 Venture capitalists and private equity funds[51] usually invest in shares in unquoted companies and expect high returns on their investment. They are typically keen to identify a clear exit route for their investment. Their desire to be involved in the management of the company varies, but they will typically want at least one director on the board. Some relevant guidance can be found in HM Treasury guidance for public sector bodies conducting trade sales.[52]

Capital markets through flotation and public listing

6.1.12 Capital markets are able to provide larger injections of equity funding than is usually possible through any other means. The transaction will, however, require significant external financial and legal advice and is only therefore likely to be an attractive option if NewCo is a substantial size and has an established track record. There are many issues to be considered before a company decides to raise money in this way, in particular: the diversion of key management time during the fund raising process and afterwards; the costs of compliance with stock exchange rules; and the consequences of share price fluctuations on staff morale and trading partners. Some relevant guidance can be found in HM Treasury guidance for public sector bodies conducting flotations.[53]

Debt raising

6.1.13 There are three main sources of debt funding:

- loans from shareholder(s);
- loans from commercial lenders (banks); and
- issuing of bonds or other transferable loan stock.

6.1.14 In a similar fashion to equity funding, these different routes of raising loans often depend on the funding stage reached, the amount of money required and the expected risk/reward balance. Loans from existing shareholders are more likely in NewCo's early stages or at initial funding; loans from banks become more likely as NewCo grows; and the possibility of NewCo raising funds through bonds will only arise when NewCo has reached a very substantial size.

Loans from shareholder(s)

6.1.15 It is often possible to arrange for the capital injection by the shareholder(s) to be in the form of a loan rather than through the issue of shares. The advantages of including some shareholder loans rather than pure shareholder equity include:

[51] Business angels can be included in this class of investor though their characteristics differ from venture capitalists and other private equity fund providers.

[52] *Getting Best Value from Trade Sales and Strategic Partnerships,* November 2000. HM Treasury. Available from the HM Treasury website: www.hm-treasury.gov.uk/pep/trade.pdf.

[53] *Getting Best Value from Flotations,* November 2000. HM Treasury. Available from the HM Treasury website: http://www.hm-treasury.gov.uk/pep/flotation.pdf.

- debt can be repaid even if there are little or no accounting profits (when no dividends are payable);
- interest on the debt provides a predetermined flow of cash back to the shareholders; and
- they can be more tax-efficient.

Loans from commercial lenders

6.1.16 NewCo may want to arrange a loan from standard commercial lenders (e.g. banks). This is usually only possible when NewCo can offer security for the loan or has a track record of generating profits. If there is still considerable commercial risk, the lender may require a guarantee from NewCo's founding partners. In normal circumstances the public sector body should avoid giving such guarantees.

6.1.17 If the public sector shareholder of NewCo is a Trading Fund, reference should be made to HM Treasury guidance on Trading Funds' participation in joint venture companies.[54]

Issuing of bonds or other transferable loan stock

6.1.18 Finance can also be raised by issuing corporate bonds, which pay investors a determined rate of interest, with fixed repayment date(s). The legal states of these is similar to a loan, but investors are usually non-banking institutions.

Grants

6.1.19 It is sometimes possible to attract grant funding for various ventures. As the name indicates, the money obtained via grant funding generally does not have to be paid back. Grants are usually only available for specific purposes, such as for R&D expenditure or investments in economically deprived areas; and many grant schemes are only open to certain types of company, such as Small and Medium Enterprises. The eligibility of NewCo for certain grant schemes will depend on whether it is classified in the public or private sector (see Section 2.4).

6.2 Commercial conduct

Fees and Charges Guide

6.2.1 The principles on which public sector bodies should set prices are set out in the *Fees and Charges Guide.*[55] The *Fees and Charges Guide* will not formally apply[56] to NewCo if it is classified to the private sector (see Section 2.4).

[54] *Guide to the establishment and operation of Trading Funds* HM Treasury Central Accountancy Team, January 2001. See footnote 8.
[55] Available from The Stationery Office (ISBN 0115600434)
[56] Paragraph 1.7 *Fees and Charges Guide,* HM Treasury.

6.2.2 If NewCo is classified to the public sector, the *Fees and Charges Guide* may apply. Note: the *Fees and Charges Guide* was last issued in 1992, when public corporations were mainly nationalised industries and were not covered by the Guide. Since then, many bodies covered by the Guide have been classified as public corporations. See paragraph 1.1.2 for the extent to which the Guide now applies to public corporations, which will be reflected in the Guide when it is reissued. In case of doubt, any concerns on this point should be addressed to HM Treasury.[57]

6.2.3 Public sector bodies should also be aware of the *Charging for Information: When and How*[58] guidance which states that for departments and agencies (other than trading funds) marginal cost pricing should be used for information which is 'raw data'. Marginal costing does not apply to 'value-added' information, which should be the type of information considered for selling into wider markets. 'Marginal cost pricing', 'raw data' and 'value added' are defined in the guidance.

Competition law

6.2.4 Regardless of whether it is governed by the *Fees and Charges Guide,* NewCo's commercial conduct is likely to be governed by both UK and EC competition rules (see Section 2.7).

6.2.5 EC law will generally apply where trade is potentially affected between EU Member States, whereas UK law will apply where the trade is mostly within the United Kingdom (although both sets of laws can apply at the same time).

6.2.6 The two main areas of competition law that will apply are:

- anti-competitive agreements (the Chapter I prohibition of the 1998 Competition Act, and Article 81 of the EC Treaty); and
- abuse of a dominant position (the Chapter II prohibition of the 1998 Competition Act, and Article 82 of the EC Treaty).

6.2.7 The other main area of competition law, merger control, will apply if NewCo decides to merge with another company; this issue is not covered further here.

Anti-competitive agreements

6.2.8 Anti-competitive agreements include price-fixing, market-sharing and imposing minimum resale prices. NewCo will be prohibited from entering anti-competitive agreements with competitors.

Abuse of dominant position

6.2.9 An undertaking is considered to be dominant if it can behave "independently of competitors and customers and ultimately of consumers" when making commercial

[57] Treasury Officer of Accounts team, on 020 7270 5314

[58] See paragraphs 33 to 38 of *Charging for Information: When and How* HM Treasury, July 2001. Available at the HM Treasury website: http://www.hm-treasury.gov.uk/mediastore/otherfiles/charging_for_info.pdf.

decisions.[59] This must be judged in the context of the relevant market. In the UK, a share of under 40% of the relevant market will be unlikely to constitute dominance, although this is by no means a hard and fast rule. It is important to note that this prohibition only refers to the abuse of a dominant position, rather than the holding or acquisition of a dominant position.

6.2.10 If NewCo may be dominant in its relevant market, it must take care to avoid abusive conduct. UK and EC law provide various examples of abuse, but the lists given are not exhaustive. The most obvious example is setting excessively high prices; in the context of Wider Markets, however, another possible abuse worth highlighting is setting excessively low prices ('predatory pricing').[60]

6.3 Tax issues

6.3.1 NewCo and its advisers will need to consider numerous tax issues, concerning both direct and indirect taxation. A number of these are listed below. The tax implications of setting up a joint venture company should be carefully thought through.[61] NewCo should be set up and operated in a way which is tax efficient. This will be important both for the commercial viability of NewCo and for attracting private sector investment. Tax considerations, however, should not affect the aims and objectives of NewCo.

Direct tax issues

6.3.2 Table 11 lists a number of direct tax issues affecting the establishment of NewCo, NewCo's operations and NewCo's shareholders.

Table 11: Direct tax issues

Establishing NewCo	
Capitalisation of NewCo	Where NewCo is capitalised by way of debt, care should be take to ensure that any interest incurred by NewCo can be fully relieved. For example, an interest deduction may not be available if the debt instrument used is treated as equity for UK tax purposes and specialist advice should be sought on this if appropriate.
Transferring property to NewCo	Any transfer of property from a taxpaying shareholder to NewCo is likely to give rise to direct tax issues. For example, the transfer of a building to NewCo may result in a capital gains liability for the shareholder, or a balancing charge for capital allowance (tax depreciation) purposes. The nature of the issues will depend on the property being transferred, the use to which the property is intended to be put and the tax profile of the shareholder. The purchase price paid for property or assets may have to be apportioned to individual assets.
Stamp duty	The transfer of assets into NewCo and the transfer of NewCo's shares will both, prima facie, be subject to stamp duty. There are a number of statutory reliefs which could minimise any potential liability and these should be considered early in the process of determining NewCo's structure.

[59] Guidance available at the Office of Fair Trading website: http://www.oft.gov.uk/html/compact/technical_guidelines/oft400.html.

[60] Predatory pricing might be present if a market-dominant NewCo embarks on a pricing strategy where it incurs losses which have the effect of eliminating a competitor, enabling it to charge excessive prices in the future.

[61] There will be, for example, differing tax implications for a joint venture company compared to other options such as in-house, or a contractual relationship with the private sector.

Table 11: Direct tax issues (continued)

NewCo's operations	
Tax rate	NewCo will be subject to UK corporation tax . This is currently set at 30% but lower rates may apply in the case of some smaller companies.
NewCo's tax status	The direct tax treatment of NewCo will turn on whether it is a trading company or an investment company. This status will determine whether certain expenditure should be capitalised or expensed for tax purposes and what tax reliefs are available.
Accounting treatment	NewCo's accounting profits are unlikely to equal its tax profits. While NewCo's accounting policies will be taken into account in determining whether certain expenditure is treated as capital or revenue for tax purposes and the timing of tax relief for revenue expenditure, the issue of whether expenditure is treated as capital or revenue is ultimately a question of law.
Capital allowances	A number of issues may arise in maximizing capital allowance claims in respect of NewCo's eligible assets. The issues will hinge on the nature of the property held by NewCo.
Capital gains	Capital gains or losses may be generated by NewCo when it disposes of capital assets. Planning will be necessary to ensure that NewCo claims all relevant reliefs and any available group relief is utilised.
Withholding tax	Payments by NewCo, especially interest and royalties for the use of intellectual property, may be subject to withholding tax. Where these payments are being made to non-residents the withholding tax liability may be reduced under a double tax agreement.
Tax losses	Tax losses can be used in a number of ways by NewCo, including surrender.
NewCo's shareholders	
Tax status	The public sector shareholder's tax status will vary from case to case and should be fully understood when structuring NewCo.
Profit extraction	Taxation of distributions from NewCo will need to be considered. If the private sector shareholder is a non-resident, it may in some cases be entitled to claim payment of a proportion of the tax credit attached to a dividend under a double tax agreement.
Residency	If the private sector shareholder is a not a UK tax resident a number of international tax issues may need consideration. For example, payments made by NewCo to the non-resident shareholder may need to be priced at arm's length (subject to the UK's transfer pricing rules) and certain payments, for example royalties, may be subject to UK withholding tax.
Loss relief	Shareholders may wish to ensure that they have access to losses incurred by NewCo. In order to achieve this care will have to be taken to ensure that the group relief or consortium relief rules can be utilised.
Exit strategies	Alternative exit strategies for NewCo's shareholders will need to be considered from a tax perspective when the structure is being planned. This will require a full understanding of the type of investor likely to become a shareholder in NewCo and the tax profile of the particular investor.

Indirect tax issues – VAT

6.3.3 Public sector bodies have varying VAT treatments, depending on whether, for example, they are central departments or NDPBs. These treatments will not apply to NewCo, regardless of whether it is classified to the public or private sector.

6.3.4 As a company, NewCo will need to register for VAT in its own right. The issues that need to be considered are:

- the VAT liability of supplies made;
- VAT recovery on expenditure; and
- the impact of any joint venture agreement on the partial exemption calculation of the public sector parent of NewCo.

Business rates

6.3.5 NewCo is unlikely to receive mandatory rate relief from business rates, as it will not be a registered charity. It may be able to receive some discretionary rate relief, but this will depend on the individual discretionary rate relief policy of the local authority where NewCo is located. Even if NewCo is a "not for profit" company, it may not be able to obtain discretionary rate relief in its particular local authority area. The levels of discretionary relief also vary, but the local authority has to fund 25% of any relief given.

6.4 Applicability of the EC public procurement rules to NewCo

6.4.1 The applicability of EC procurement rules with regard to finding a joint venture company partner is dealt with in Section 3.1. However, NewCo itself may have to abide by EC public procurement rules if it constitutes a "contracting authority", as defined in the EC Directives and implementing UK regulations.

6.4.2 The definition of contracting authority is complex, and if there is any doubt over the issue then advice should be sought from OGC. Normally, however, NewCo type companies classified to the private sector will not count as contracting authorities and will not be covered by the EC public procurement rules.

ANNEX A – CLASSIFICATION

A1 Decisions on the classification of NewCo to the public or private sector will be primarily based on who owns the majority of voting shares and who has control over the appointment of directors (see Section 4.2). Other issues which the ONS may take into account include:

- *Ownership.* Even where the public sector body owns 50% of NewCo's shares or fewer, the use of different classes of share with different rights may still give the public sector body effective control.
- *Multiple sponsorship.* Where a body is owned or controlled by a number of public sector bodies it is the overall weight of the public sector that counts. Hence, if five public sector bodies each have a right each to appoint one director, and the board comprises nine or fewer directors, the body will be classified in the public sector.
- *Special (or golden) shares.* The existence of very narrowly defined Government powers, directed primarily at preventing undesirable changes of ownership, or the disposal of material assets, need not amount to control.
- *Special terms in NewCo's constitution.* NewCo's Memorandum and Articles may have terms that require the public sector founder's consent for certain actions, or before the Memorandum and Articles may be changed. Where such restrictions are time limited and are intended to give an initial period of stability to a new body, they need not amount to control. Permanent restrictions over important parts of NewCo's work would normally amount to control, depending on whether such control is active or passive. Setting out the purpose and operational guidelines for NewCo when it is set up would be passive control; defining circumstances in which the public sector body could intervene and make decisions affecting how the organisation is run is active control. Active control could amount to actual control; passive control need not do so.
- *Special regulation.* Regulation over external actions – such as price regulation, and regulation of markets – is unlikely to amount to control. Where regulation extends to internal management – for example pay levels or borrowing – then it could be seen as taking control.

A2 The constitutional documents of NewCo and the shareholders' agreement will set out the control rights of each partner. The rights given to a public sector partner in a joint venture can appear to be significant in terms of control. However, such rights should not necessarily mean that NewCo has to be classified to the public sector, provided that the rights are similar to those enjoyed by the private sector partner and exist solely to protect the public sector founder's financial stake in NewCo.

A3 Nonetheless, Government rights giving control over the joint venture in order to further Government policies (such as locating an operation in a particular part of the country) or to avoid political problems (such as big pay increases for directors) could be enough to tip the balance in favour of classification to the public sector.

ANNEX B – STATE AIDS

B1 State aid issues can arise when the public sector confers a direct or indirect financial advantage on NewCo (see Section 2.6). The key test is whether the recipient of the advantage is receiving a benefit which they would not have received in the normal course of business. The relevant article of the EC Treaty (Article 87) can be broken down into four tests to establish whether state aid rules apply. A state aid will only be present if all four tests are met:

- *Is the financial advantage granted by the State or through State resources?* This refers to the many direct and indirect ways in which a state aid be granted. There must be a financial cost to the state for a state aid to be present.
- *Does the measure favour certain undertakings or the production of certain goods?* Only measures favouring certain recipients are the concern of the state aid rules; general government measures such as economy-wide tax rates are not covered and benefits for individual citizens are not state aids.
- *Is the activity tradable between Member States?* Although in many cases joint venture companies may be planning activities in the UK only, if either/any of their parent companies are economically active or potentially active in other EU countries, the state aid rules will normally apply.
- *Does the measure distort or have the potential to distort competition?* This is the crucial factor when determining the applicability of the state aid rules.

B2 In the context of Public Private Partnerships, the last test, concerning the distortion of competition, could be important. Possible distortion of competition could occur at a number of different levels in a Wider Markets PPP. A benefit may accrue to the private sector partner(s) in a joint venture company deal, or as a cross-subsidy to NewCo itself, or to the ultimate consumers. A Wider Markets proposition could, however, be framed in such a way as to minimise the potential for distortion of competition, in ways such as the following:

- *Possible aid to private sector partner?* This can often be addressed by a competitive and fully transparent selection process, with the private sector partner paying the appropriate premium for entering into NewCo.
- *Possible aid to NewCo?* This can usually be addressed by fair and commercial pricing of all the asset(s) contributed by the public sector partner to NewCo, also translating into a fair share allocation and fair dividend policies. Care must be taken with hidden assets, such as intellectual property rights, which may remain in the public sector but be used by NewCo after its creation. Use of such assets must be charged in full to NewCo at commercial rates or made available to NewCo's competitors on equal terms.
- *Possible aid to ultimate consumers?* This can be addressed by fair and commercial pricing of the good/service supplied by NewCo.

B3 The DTI produces thorough guidance on the state aid rules, revised most recently in 2001.[62] Queries about particular projects can be addressed to the DTI State Aid Policy Unit, email: sapu@dti.gsi..gov.uk or telephone 020 7215 4498.

[62] Available at the DTI website: http://www.dti.gov.uk/europe/stateaid/guide/index.htm.

ANNEX C – COMPETITION LAW ISSUES WHEN SETTING UP NEWCO

Major provisions

C1 The two main aspects of competition law to be considered when setting up NewCo are:

- merger control (under the 1973 Fair Trading Act and the EC Merger Regulation); and
- anti-competitive agreements (the Chapter I prohibition of the 1998 Competition Act, and Article 81 of the EC Treaty).

C2 The other aspect of competition law, abuse of a dominant position in a market, may also be relevant after NewCo has been set up, particularly if the activities of NewCo are in a niche or uncompetitive area. This is discussed further in Section 6.2.

Merger control

C3 The formation of a joint venture company may constitute a "merger situation" under the UK's Fair Trading Act, if an "enterprise" ceases to be distinct. This may occur if one or more of NewCo's founders allocate part of their assets, business, IP rights or personnel to NewCo. There is no obligation to notify such a "merger" to the OFT. However, the OFT may evaluate a joint venture company agreement if it feels that it may have an anti-competitive effect. It will only evaluate a NewCo which satisfies either of the following tests:

- share of supply test – where NewCo will have over 25% market share in a properly defined market; or
- assets test – where the gross value of the world-wide assets being allocated to NewCo exceeds £70 million.

C4 The EC Merger Regulation (ECMR) may apply if NewCo is a "full-function joint venture" (i.e. if it performs the functions of an autonomous economic entity, which is likely to be the case for joint venture companies covered by this guidance) and is sufficiently large-scale to merit investigation (the thresholds for investigation include a worldwide turnover of the joint venture partners having to exceed 5 billion euros[63]). However, if each of the partners achieves more than two-thirds of their aggregate turnover within the UK, then the ECMR rules will not apply.

C5 Thus most Wider Markets deals are likely to avoid EC scrutiny as mergers.

Anti-competitive agreements

C6 The joint venture company agreement may also constitute an anti-competitive agreement, if it can be judged to have an appreciable effect on competition. In general, in the UK context an agreement is unlikely to be judged to have an appreciable effect on competition if the parties' combined share of the relevant market is less than 25%, although this will not always be the case.

[63] There is a second, lower threshold of 2.5 billion euros, which applies if certain conditions are met.

C7 There are various exemptions from the UK and EC provisions against anti-competitive agreements. There is an exemption for research and development (R&D), for example, which seeks to encourage co-operation in R&D, but competition authorities will be concerned to ensure that any R&D arrangements (particularly if they extend to joint production and/or exploitation) do not unduly prejudice potential competition in the future. NewCo's founders may have to notify their joint venture agreement to the relevant competition authority if, after consulting their advisers, there are still serious doubts that their joint venture agreement could have an appreciable effect on competition.

ANNEX D – ACCOUNTING TREATMENT

D1 For accounting purposes, the public sector sponsor's relationship with NewCo can be classified as that of a subsidiary, associate or 'joint venture' as briefly described in the table below. The term 'joint venture' has a narrow sense in this context, and should not be confused with the wider meaning (incorporating subsidiaries and associates) used elsewhere in this guidance.

D2 Details of accounting classification and treatment can be found in the relevant accounting standards (FRS 2 for subsidiary undertakings and FRS 9 for associated undertakings and joint ventures) or by contacting HM Treasury (Nick Bailey, Central Accountancy Team, 0207 270 4535).

Entity	Nature of Relationship	Description of the Defining Relationship
Subsidiary	Investor controls its investee	Control is the ability of an entity to direct the operating and financial policies of another entity with a view to gaining economic benefits from its activities. To have control, an entity must have both: the ability to deploy the economic resources of the investee or to direct it; and the ability to ensure that any resulting benefits accrue to itself – with corresponding exposure to losses – and to restrict the access of others to those benefits.
Associate	Investor holds a participating interest and exercises 'Significant Influence'	The investor has a long-term interest and is actively involved, and influential, in the direction of its investee. This is done through the investors participation in policy, decisions covering the aspects of policy relevant to the investor, including decisions on strategic issues such as: • the expansion or contraction of the business, participation in other entities or changes in products, markets and activities of the investee; and • determining the balance between dividend pay outs and re-investment.
Joint Venture (See para D1)	Investor holds a long-term interest and shares control under a contractual agreement	Acting together, the venturers control the venture and there are procedures for such joint action. Each venturer has (implicitly or explicitly) a veto over strategic policy decisions.

D3 If the sponsoring public sector body is outside the resource accounting boundary (e.g. trading funds, NDPBs, nationalised industries, public corporations, NHS providers), then the accounting treatment of NewCo will follow the relevant accounting standards. Under FRS 2, subsidiary undertakings should be consolidated in the accounts of the parent body on a line by line basis to present financial information for the group as a single economic entity. FRS 9 establishes that associate undertakings should be incorporated into the parent bodies accounts using the 'equity' method[64], and joint ventures using the 'gross equity' method.[65] Where the sponsor body has no subsidiaries and therefore does not prepare consolidated accounts, its interest in NewCo will be accounted for as a fixed asset at valuation. However, FRS 9 requires the disclosure of information on associate undertakings and joint ventures equivalent to that required in consolidated accounts. This can be done either by preparing pro-forma 'consolidated' accounts including NewCo's results and gross assets and liabilities, or by simply disclosing the relevant amounts for NewCo and the effect of including them.

D4 Section 1.5 of the Resource Accounting Manual will apply to public sector sponsors inside the Resource Accounting Boundary (e.g. government departments, on Vote agencies, NHS purchasers). In practice, this will mean that interests in subsidiary undertakings, associate undertakings and joint ventures are treated as a fixed asset investment at a valuation (on the assumption that NewCo, as a public corporation, is itself outside the resource accounting boundary). However, in these circumstances, the public sector body should still disclose equivalent information required by FRS9 for associate undertakings and joint ventures (see paragraph D3).

D5 Public sector subsidiaries, associates and 'joint ventures' will be consolidated into Central Government Accounts and/or Whole of Government Accounts in due course.[66]

[64] Under the equity method the sponsor body should show its share of NewCo's operating result immediately after the group operating result in the profit and loss account, and disclose its share of the net assets of NewCo as a single figure in its consolidated balance sheet.

[65] Under the gross equity method the sponsor body should show its share of NewCo's turnover and operating result immediately after the operating result of the group, and disclose its share of the gross assets and gross liabilities of NewCo on the consolidated balance sheet.

[66] For details of the Whole of Government Accounts Programme see www.wga.gov.uk.

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