

## KEY POINTS

- To determine the relative value of each JV party's capital contribution to the JVCo, each JV party's contribution is valued differently based on what was contributed and when it was contributed.
- Structuring the holdings of differing types of JV parties faces at least three constraints.
- Although the model JVA anticipates that the JVCo will be formed after the JVA is signed, a JV party may form the JVCo ahead of time.

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## Joint venture agreements: part 5 – follow the money

The model JVA distinguishes between initial capital commitments, covered in art 4, and future 'unplanned' capital calls, covered in art 5 (which will be discussed in the next instalment). Article 4.1 sets out the intended equity percentage of each JV party after giving effect to all capital contributions contemplated in art 4. As discussed below, these percentages are not based on any objective measure of the differing capital contributions, but rather reflect their entitlements to take money out of the JVCo – through dividends and other distributions or the sale of the shares of the JVCo or its assets.

Article 4.2 assumes each JV party will make an initial cash contribution 'at such time or times as shall be fixed by the Board of Directors after all Regulatory Approvals have been obtained'. Article 4.3 provides for

This article is fifth in a series examining project development and finance joint ventures ('JVs') based on the International Trade Centre incorporated joint venture model agreement ('JVA') among three or more parties.<sup>1</sup> This instalment discusses the initial commitment of the JV parties to contribute to the capital of the joint venture company ('JVCo'), and their respective rights to share in any dividends, distributions or proceeds of any sale of the shares or assets of the JVCo, as set out in art 4 of the model JVA.

project. Each JV party plays a different role in the process, adding value in different ways at different stages of developing the project, so its percentage of equity is calculated differently. In some cases, a single JV party may combine two or more of these attributes, but each type is treated as distinct in this article.

First, many project JVs originate with an entrepreneurial JV party who identifies the business opportunity, develops it to a certain stage, and then identifies potential JV parties

investment of initiative, effort and (a smallish sum of) money.

Secondly, many project JVs include a JV party recognised for its competence in the construction, management and/or operation of the particular infrastructure project. Such an 'operator' JV party may be necessary to satisfy the qualifications to participate in the tender for the licence, contract or concession. A good operator JV party can also be instrumental in obtaining institutional debt and equity for the JVCo, thereby improving its access to, and reducing its cost, of capital. The operator JV party will often seek recognition of the goodwill and competence it brings to the JV through a larger percentage of ownership in the JVCo for the same level of cash contribution and/or, as discussed in the first instalment of this series, through the extraction of value in the form of management fees or royalties pursuant to an ancillary agreement with the JVCo. It is not uncommon for the operator JV party, once joining the JV, to succeed the entrepreneur JV party in assuming a leadership role for the JV. This is not always so, however, and the entrepreneur JV party sometimes remains in the leadership role.

Third, project JVs in developing markets or otherwise outside the markets in which the other JV parties normally conduct business sometimes include a 'local' JV party. The local JV party's contributions may include local market knowledge, impressing the government authority issuing the licence, contract or concession that locals are included (or even meeting a bidding requirement that the

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'further' capital contributions, 'in cash, real estate, personal property including machinery and tools, intellectual property, services or other in-kind contributions . . . at times fixed by the Board of Directors'. These contributions should all be anticipated in the business plan contemplated in art 2.3.

The model JVA takes a simplistic view of JVCo capital contributions as either cash and in-kind, but implicitly assumes every JV party will pay the same price for its shares and that their contributions are made concurrently. For infrastructure project JVs, a more likely scenario involves as many as four types of JV party. They may contribute at earlier or later stages in the evolution of the JV from an idea to a JVCo with a licence, concession or contract to build, own and operate an infrastructure

and invites them to join together in a JV.

The entrepreneurial JV party will expect the value thus created to be recognised through its ownership in the JVCo. The payment for its shares in terms of cash or in-kind assets with existing value may be nominal, as the real consideration for the entrepreneur's shares is the value created through establishing the JV. While one could consider such JV party as having thereby earned its shares in the JVCo in exchange for past services, saying so may have adverse tax consequences for the entrepreneurial JV party and may also run afoul of in-kind contribution valuation requirements in some jurisdictions, particularly as the value of the shares received is likely to exceed the value of the time spent, reflecting the 'entrepreneurial' return on the founder's

## Feature

### Biog box

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JV include local participation). While the other JV parties will endeavour to select a local JV party who adds as much value as possible, the local party may not be able to contribute much cash (especially in developing countries) and may not be as sophisticated in the business of the JV as the entrepreneur or operator JV parties. The local JV party's primary contribution may simply be to satisfy a requirement of partial local ownership.

Fourth, many project JVs include institutional equity. Although cash is the oxygen for an infrastructure project, the contribution of the institutional investors is more of a commodity than the contributions of the other JV parties. The equity issued to the institutional investor JV parties will thus be priced at a market-based return on their cash investment. This is derived by applying an appropriate discount rate to future free cash flow expected from the project to determine its net present value, and allocating the percentage of equity to the institutional investors necessary

or common equity with a net present value based on discounted cash flows equal to the market cost of equity. The operator JV party will take the percentage that is market for its intangible contributions (or such higher amount as may be required to qualify for the licence, contract or concession or as the investor may want for strategic purposes). If higher, the difference will be covered by cash to be paid in by the operator JV party. Next, the local JV party's share will be allocated and may range from a token amount to a more substantial amount. The remaining equity belongs to the entrepreneur – a rough measure of value created – and could range from a small percentage to a majority interest.

These competing constraints make it more likely that in-kind contributions will be made before, upon or soon after the formation of the JV, while the cash contributions of institutional investors are more likely to be spread over the project development and construction period, and any initial period

taxation of the implicit gains to be deferred and/or to benefit from lower capital gains rates.

Similar pacing of entry into the JVCo may allow the operator party and the local party to buy in at price per share higher than that paid by the entrepreneur but lower than will be paid by the institutional investors. The institutional investors can join the JV either just before the bid is submitted, or after the licence, contract or concession is awarded, as their money is typically not needed until the project commences.

Article 4.4 contains representations and warranties regarding in-kind contributions, and art 4.5 sets out the JVCo's remedies for default. These topics will be discussed in a later instalment.

Optional language for art 4.5 also contemplates that the JVCo's board can arrange an independent valuation of in-kind contributions. While such a provision may be appropriate in some circumstances, as among sophisticated JV parties, the arm's-length negotiation process and the valuation of the various contributions made by the JV parties in view of the JV's business plan is typically the best measure of value and risk allocation and should not be disturbed by an outside valuation.

Article 4.6 contains a procedure for amending ancillary agreements – requiring a majority vote at a shareholders meeting. This provision could be moved to the decision-making processes in arts 8 (shareholders) and 9 (board) of the model JVA, which will be discussed in subsequent instalments. Amending an ancillary agreement is simply one of many decisions – and is better included in the same part of the JVA that addresses the decision-making process generally.

In conclusion, to determine the relative value of each JV party's capital contribution to the JVCo, as the old adage goes, 'follow the money' – but follow how it goes out and not how it comes in, as each JV party's individual contribution is valued differently based on what was contributed and when it was contributed. ■

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to provide the required rate of return. The discount rate reflects the nominal interest rate plus the perceived risk of the project.

Structuring the holdings of differing types of JV parties faces at least three constraints: minimising adverse tax consequences; complying with company law requirements for valuing in-kind contributions; and satisfying any qualification criteria for the licence, contract or concession sought or obtained by the JV.

To accomplish the share ownership allocations in art 4.1, the JV's business plan must include, among other things, a cash flow model and a capitalisation table. Developing the cash flow model and capitalisation table is an iterative process due to the interdependencies between the two, and with the various potential sources of capital. Among the JV parties, the interest of the institutional investors will be that percentage of the ordinary

of operations during which the JVCo has negative cash flow.

Although the model JVA anticipates that the JVCo will be formed after the JVA is signed, a JV party may form the JVCo ahead of time. For example, the entrepreneur may form the JVCo before admitting the other JV parties, or even identifying and inviting them to join the JV. Initially, the entrepreneur would own 100 per cent of the equity, fully paid up with a nominal cash contribution. The entrepreneur thus vests its ownership without significant cash, and houses the business opportunity in the JVCo. When other JV parties are admitted, they can buy shares at a price that implicitly values the entrepreneur's shares at more than the subscription price paid. This approach allows the entrepreneur to capitalise its pre-JVA initiative, effort and services without running afoul of in-kind contribution rules and possibly allowing

1 The model JVA discussed may be found at [www.jurisint.org/doc/orig/con/en/2005/2005jiconen1/2005jiconen1.pdf](http://www.jurisint.org/doc/orig/con/en/2005/2005jiconen1/2005jiconen1.pdf).