Feature

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KEY POINTS

- Identifying the Joint Venture parties seems easy and inconsequential but this is not so.
- If a dispute cannot be resolved amicably, the recitals can provide a court or arbitral tribunal with sufficient factual information and individual Joint Venture party objectives to interpret the Joint Venture Agreement ('JVA') so as to give commercial efficacy to the intentions of the parties.
- The very term 'joint venture,' although loosely used to refer to a multi-party relationship, can have legal consequences beyond those set out in the JVA.

Joint venture agreements: part 2 – introducing the characters and setting the scene

This is the second article of a series that examines project development and finance joint ventures ('JVs') based on the International Trade Centre incorporated joint venture model agreement among three or more parties.[1] This instalment outlines the process of properly introducing the characters and setting the scene for the joint venture agreement ('JVA').

Identifying the JV parties seems easy and inconsequential. Not so. When it is time to negotiate the JVA, the specific legal entities that will participate in the JV may not yet have been clearly defined. Each individual involved in the preliminary discussions may represent a 'group' of related companies.

For tax, regulatory and other reasons, a JV party may want to incorporate a separate entity to serve as its 'shareholder' of the joint venture company ('JVCo'). Such entities are often empty shells, with no assets other than their holdings in the JVCo. Also, where one JV party will provide services to the JVCo, that JV party may have good business reasons to use a different legal entity to provide such services than the legal entity that becomes a shareholder of the JVCo. Often, neither entity is the parent company.

However, each JV party will also want assurances that its counterparties have the financial resources to support their funding commitments to the JVCo as well as their representations, warranties, indemnities and other covenants in the JVA and related JV documentation. At the extreme, each JV party may want to look upstream to the ultimate parent entity of each other JV party. Also, if the JV is bidding for a government concession, licence or contract, then the government evaluator may want assurances that the upstream entities are committed financially, legally and with their management resources and know how.

For these purposes, each JV party must identify its ultimate parent entity. That entity may be a publicly traded company, individual, venture fund or other silent owner. For legitimate reasons, such upstream persons may resist being contractually bound to the other JV parties or a government agency. For example, an individual who is an ultimate parent may want to keep his personal assets and liabilities legally separate from his business assets and liabilities. He may also have already entered into affirmative and negative financial covenants with lenders or other parties, in matters unrelated to the JV at hand, that limit the additional commitments he is able to take on. The same could be true of an ultimate parent company. A passive venture fund may not want to take on any contractual liability due to the manner in which it has been organised.

Sometimes it is sufficient to identify a business entity that is not the ultimate parent, but is adequately capitalised and effectively functions as the parent of the group. Other times, as where an individual has distinct holdings without any common ownership other than his individual holdings, it is necessary to obtain some comfort from that individual on appropriate matters. These may include, for example, duties of loyalty to the JV and commitments not to compete. They may also include disclosure of other holdings, particularly where such holdings are subject to scrutiny by a government regulator or evaluator of the JV. Such matters may be addressed in guarantees, ancillary undertakings, comfort letters and other such devices, which are typically very context specific and the subject of heavy negotiation.

It is also customary that the JVCo become a party to the JVA after it is incorporated. As mentioned in part 1 of this series, the JV parties will sometimes delay incorporation of the JVCo until the JV has been awarded a government concession, licence or contract – and, if unsuccessful, will simply wind up the activities of the JV without incorporating the JVCo.

"It is important for the JVCo to become a party because it will often have its own directors, officers and/or employees."

It is important for the JVCo to become a party because it will often have its own directors, officers and/or employees (who may be independent from the JV parties) and will have separate assets and liabilities. The JVCo will thus evolve into a separate organism from each JV party, and the JV parties together, so it should be contractually bound to follow the rules established by the JV parties for the JV.

Sometimes, the JVCo may consist of two or more entities, perhaps with a parent JV entity formed in a tax efficient jurisdiction, where each JV party will hold its shares in the

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JV, and a wholly owned subsidiary JV entity incorporated in the jurisdiction where the project is located.

The recitals in the JVA also play an important role by setting out important factual information and business objectives for each JV party as well as for the JV. This information provides, within the four corners of the JVA, the rationale for why the JV parties are forming the JV, what each is expected to contribute to the JV, what each expects to get out of the JV, and other relevant background information. This information sets the scene for the JV's storyline, and on which a long-term relationship may be founded.

The recitals thus supply vital information for interpreting the JVA and related documents if a dispute ever arises. Such information may assist the JV parties in avoiding disputes or resolving them amicably by reminding them what they were expected to do and what they expected to receive. If a dispute cannot be resolved amicably, the recitals can provide a court or arbitral tribunal sufficient factual information and individual JV party objectives to interpret the JVA so as to give commercial efficacy to the intentions of the parties. This may be particularly important when the JVA is governed by a common law system (such as English or New York law, two common choices of law in project development and finance) that imposes the so-called 'parol evidence rule' limiting the ability of a court or arbitral tribunal to hear evidence of the intentions of the parties that contradicts or adds to the terms in the written contract.

The model JVA defines certain terms in art 1 and other terms in context. We will generally discuss defined terms as we work through the other provisions of the JVA. However, this instalment briefly introduces three defined terms that merit special attention at the outset: 'affiliate,' 'board of directors' and 'joint venture'. These terms are not merely shorthand. They represent significant legal and factual concepts underpinning the entire JV relationship.

The term 'affiliate' establishes the requisite level of kinship between a JV party and a third person to trigger legal consequences under the JVA. Following the lengthy discussion of 'parties,' one can imagine that the term 'affiliate' raises a host of issues and tensions and requires different definitions in different contexts. The model JVA defines affiliate as direct or indirect ownership of 50 per cent or more of issued share capital or control of 50 per cent or more voting rights. This definition may be appropriate for some situations but possibly not others.

For example, the JVA might provide blanket permission, in advance, for each JV party to restructure its shareholdings in the JVCo from time to time, as long as ownership remains 'in the family.' For this purpose, an 'affiliate' is commonly defined, for a given entity, as any other entity that controls, is controlled by or is under common control with the first entity. In other words, any two entities with the same ultimate parent entity are considered affiliates. For such preapproval purposes, any broader definition may be considered by the JV parties as too permissive because they may no longer be dealing with the same ultimate person as their counterparty.

On the other hand, the JV parties may want to take a more expansive view of affiliate in other contexts. For example, where the JV bids for a government concession, licence or contract, the tender rules may require disclosure of all related parties with very nominal overlap (such as 5 per cent common ownership), and may even forbid such common ownership with persons restricted from participating in the tender (such as an existing licencee when a new licence is being issued to increase competition).

Similarly, in identifying potential conflicts of interest between the JV parties and the JV, and imposing contractual limitations on related party transactions, the JV parties may also want to define affiliate broadly – perhaps not as broad as 5 per cent common ownership, but maybe broader than a control test.

Finally, for financial and tax accounting purposes, the JV parties may stipulate certain rules that come into play when the degree of common ownership of a JV party and the JVCo, or other affiliates of the JV party, reaches certain thresholds that require consolidation or other group treatment under applicable financial accounting principles or tax laws. These percentages are typically as low as 20 per cent to 30 per cent.

Two additional defined terms of significance can be considered together, 'board of directors' and 'joint venture'. Both terms go to the nature of the relationship among the JV parties and the JVCo. Will the relationship be akin to a partnership, in which the JV parties have implied fiduciary duties to each other, or will it be a purely contractual relationship, in which the duties of the JV parties are limited to those set out in the JVA and ancillary agreements? The very term 'joint venture,' although loosely used to refer to a multi-party relationship, can have legal consequences beyond those set out in the JVA, so the JV parties and their lawyers must take care not to use such terminology unless that is what is meant. In some jurisdictions a 'joint venture' imposes special duties on JV parties akin to those of partners.

The model JVA contemplates a board of directors as the principal executive body of the JVCo. However, in most JVs, the JV parties anticipate that their individual representatives on the governance body will vote in accordance with the interests of the JV parties who appointed them. This notion is at odds, in some jurisdictions, with the statutory and implied duties of directors to act in the best interest of all shareholders of the JVCo. This is an area of much misunderstanding, and one in which parties can easily get things wrong, either in the JVA itself or in their stewardship of the JVCo. The JV parties should thus identify whether individuals are acting in their capacity as directors, with attendant fiduciary duties, or in their capacity as shareholder representatives. The JV parties must also pay particular attention to the legal regime in which the JVCo is incorporated, the type of entity, and so on.

Careful treatment in the JVA of the provisions and concepts discussed in this article can introduce properly the characters and set the scene to establish a solid foundation upon which to build the JV. We will continue working our way through the model JVA next month. ■

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