Feature

KEY POINTS

- The relatively short and cryptic provisions of art 6 cover some very important matters in the life of the joint venture prior to the birth of the joint venture company.
- Lawyers representing the joint venture parties in negotiating the joint venture model agreement should give these provisions the attention they merit and, when appropriate supplement them substantially to address the specifics of the joint venture being negotiated.
- It is a good idea, to the extent practical, to avoid entering into pre-incorporation undertakings that survive their assumption by the joint venture company.

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Joint venture agreements: part 7 – prenatal care for the JVCo and its parents

This article is seventh 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.[1] This instalment discusses art 6 of the JVA, which sets forth the responsibilities of the JV parties for the incorporation of the joint venture company ('JVCo') and the handling of their contributions and undertakings made on behalf of the JV prior to incorporation of the JVCo.

Article 6.1 directs that the JV parties will jointly carry out the administrative steps required for the establishment and registration of the JVCo. As an alternative option, the JV parties can appoint one of themselves or a third party to handle these matters. In this regard, readers are advised to consider the issues contained in the discussion of art 3.1 in Part 4 of this series.

Article 6.2 apportions the expenses of establishing and registering the JVCo. It allows the drafter to have the JV parties pay the costs either in equal proportions or in proportion to their percentage interests in the JVCo.

Article 6.2 also allows the drafter to have the JVCo either reimburse the JV parties for these expenses or give them a credit against the subscription price for their shares. In either case, whether the cash is circled around by a reimbursement which essentially refunds part of the subscription price for the shares or whether it is credited, this mechanism allows the JV parties to apply their share of such expenses to their required capital contributions.

A more significant and related topic, but one not addressed in art 6, is the handling of other pre-incorporation expenses and in-kind contributions paid or provided by the JV parties, which are likely to be considerably more than the costs of establishing and registering the JVCo. These contributions include moneys spent on things such as travel, lawyers, accountants, consultants, bankers and bid preparation and submission, as well as uncompensated time of executives and personnel of the JV parties, in each case for the benefit of the JV (such as legal fees and time spent preparing the bid document) as opposed to a specific JV party (such as legal fees and time spent negotiating the JVA). In theory, such contributions to the JV could be treated as capital contributions under art 4.3 as discussed in Part 5 of this series, although art 4.3 appears to focus on prospective contributions to capital made after the JVCo has been formed. The drafter could thus cover the topic either in art 4.3 or art 6.2.

Crediting the pre-incorporation contributions of the JV parties as part of their capital in the JVCo has several business purposes. One reason is to allow the JV parties to capitalise their contributions rather than treating them as current expenses (which may have positive and/or negative financial and tax accounting consequences, depending on the circumstances, so the lawyers will need to confer with their clients on such matters). From a financial perspective, capitalising pre-incorporation contributions reduces the negative impact on each JV party's current income statement by not treating the contributions as expenses deducted from revenues in calculating profits and losses while allowing the contributions to be carried on the books as an investment in the JVCo and deducted from any gain on that investment in the future. From a tax perspective, capitalising the contributions similarly disallows them from being deducted from current gross income in computing taxable income, but likewise allows them to be included in the tax basis in the JVCo shares and therefore reduce the amount of taxable gain realised in any future disposition of those shares. This involves a tradeoff between shifting any negative financial impact to the future or retaining any positive tax impact in the present, and the JV parties may not be similarly situated in how they are impacted.

Another reason to capitalise pre-incorporation contributions is to demonstrate a greater amount of equity investment in the JVCo (essentially one that reflects the full level of investment in the JV). This can improve the JVCo's ability to meet equity-debt ratios with lenders without the JV parties being required to invest more additional cash than necessary. It can similarly aid in meeting any minimum equity-debt ratios imposed by the government authority issuing the licence, concession or contract to be awarded to the JVCo. In addition, if a dispute with such government authority or other person ever arose due to the termination or expropriation of the licence, concession or contract, the JVCo's proof of its sunk costs would more easily demonstrate the full level of investment by the JV parties and therefore any award of damages or compensation based on wasted costs rather than benefit of the bargain would stand a better chance of making them whole.

The JV parties might also consider establishing rights of contribution from each other for any imbalance of pre-incorporation expenses if the JVCo is not subsequently incorporated and capitalised. Under these circumstances, any JV party that incurred more than its agreed share of the total costs

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with the understanding that it would later be compensated through a credit toward its capital contribution would otherwise be left bearing a disproportionate share of the expenses of the aborted JV. Sometimes this imbalance of risk may be expressly agreed and intended, but, where it is not, a make-whole provision should be included in the JVA. However, the model JVA does not include such a provision.

Article 6.3 apportions liability among the JV parties for any pre-incorporation undertakings made by one or more of the JV parties in the name of or on behalf of the JVCo, provided that such undertakings were given by agreement of the JV parties. The two options are for all the JV parties to be jointly and severally liable either in equal shares or proportionately to their equity interests in the JVCo. Such pre-incorporation undertakings on behalf of the JV or JVCo should be distinguished from those made by a JV party on its own behalf. For example, in a bid for a licence, concession or contract, each JV party may be required to make certain representations and warranties regarding the information about itself that is included in the bid. These are individual undertakings and should remain the responsibility of the JV party that is required to give them. In contrast, one or more of the JV parties may be required to give certain undertakings regarding the JV's commitments to build, own and operate the infrastructure project if the JV is awarded the licence, concession or contract. These should typically be considered undertakings on behalf of the JV. Similarly, if one or more JV parties enter into pre-incorporation contracts with vendors of the JV or would-be vendors of the JVCo, then these should also typically be considered undertakings on behalf of the JV. Although the model JVA refers to such undertakings generically, it may be possible for the drafting lawyers to refer expressly to all such undertakings, and the JV parties who gave them, by attaching a schedule listing them to the JVA.

The JV parties are also implicitly agreeing to have reciprocal duties and rights of contribution and reimbursement if a party giving an approved pre-incorporation undertaking is ever called upon to make good on the undertaking. However, the lawyers drafting the JVA would do well to make this more explicit, and include standard contribution provisions in the JVA itself or in a separate contribution agreement.

Article 6.4 further provides that, if agreed by the JV parties, the JVCo may assume any or all of the undertakings discussed in art 6.3. It further provides that the JV party that gave the undertaking will be 'released' and the JVCo will indemnify such JV party. If any significant pre-incorporation undertakings by any JV parties are expected, this relatively short provision will most likely require significant focus by the JV parties and their lawyers in negotiating the JVA and the relevant contracts containing the pre-incorporation undertakings.

For example, if a performance bond is required to be posted with the government before the JVCo can be incorporated and/or sufficiently capitalised so as to obtain the bond in its own name, then one or more of the JV parties may be required to give financial support to the issuer of the bond. Obtaining full or partial release from that financial support later is unlikely unless this is addressed with the issuer of the bond at the time the arrangements to issue the bond are made. While the JVCo may agree to indemnify the JV party giving the undertaking, the circumstances under which the performance bond may be exercised by the government are also likely to be circumstances in which the JVCo would be unable to meet its indemnification obligations.

Although a JV party may also have a right of contribution from the other JV parties under art 6.4, to the extent the JVCo does not or cannot meet its indemnification obligations, the circumstances under which those rights arise are again likely to be in a contentious scenario for the JV. The remaining JV parties may therefore resist fulfilling their contribution obligations. In addition, the JV party seeking reimbursement will be forced to go after each JV party separately for only a fraction of the total amount of reimbursement due.

Thus, it is a good idea, to the extent practical, to avoid entering into pre-incorporation undertakings that survive their assumption by the JVCo. The JV parties should therefore either obtain a clear understanding from the relevant third party that they will be released when the JVCo assumes the relevant obligation, or should resist giving the undertaking in the first place. This will not always be possible, and hence the contribution/reimbursement obligations of the other JV parties in art 6.3 and indemnification obligations of the JVCo in art 6.4 provide some measure of protection, albeit subject to the weaknesses discussed.

> "The JV party seeking reimbursement will be forced to go after each JV party separately for only a fraction of the total amount of reimbursement due."

The relatively short and cryptic provisions of art 6 cover some very important matters in the life of the JV prior to the birth of the JVCo. The drafting and substance can have significant long-term financial consequences for the JV parties and the JVCo. Lawyers representing the JV parties in negotiating the JVA should give these provisions the attention they merit and, when appropriate supplement them substantially to address the specifics of the JV being negotiated. ■

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