Feature

KEY POINTS

- Setting parameters for future capital calls to meet unanticipated funding requirements of the JVCo is a tricky and contentious aspect of drafting and negotiating the JVA.
- In choosing among the drafting alternatives provided in art 5, or in customising them, lawyers should pay close attention to the corporate finance realities likely to be faced by the JVCo and the investment protection and anti-dilution concepts that commonly arise in this context.
- For simplicity, preemptive rights are preferable to value anti-dilution provisions as they avoid the 'who shoulders the loss of value' problem.

Author Richard Keck

Joint venture agreements: part 6 – when the money runs out

This feature is sixth 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 5 of the JVA, which sets forth the procedure for the JV parties to provide funding and financial support to the joint venture company ('JVCo') beyond that contemplated in the original business plan. As discussed in part 5 of this series, art 4 of the JVA covers future funding requirements that are anticipated in the business plan.

Unanticipated funding needs may result from favourable or unfavourable developments in the JVCo's business. Positive developments may include new business opportunities, such as the chance to expand the scope of the JVCo's business due to new technology, markets or licensing opportunities. For example, a telecom JVCo may face an opportunity to acquire additional radio spectrum for existing or new services. Positive developments might also include faster than anticipated growth in the business, creating a need for additional working capital.

Negative developments may include cost overruns or delays in the construction of the JVCo's infrastructure. They might also include poorer market performance than anticipated. For example, a telecom JVCo may not achieve expected market share or may experience greater than anticipated price erosion due to competition from existing operators or new entrants. Similarly, the operator of a toll road might not realise anticipated revenues due to changes in traffic patterns.

Article 5.1 of the JVA establishes the basis for the JVCo to call on the JV parties to meet any unanticipated funding shortfall. It applies only if the JVCo's board 'considers at any time that additional funding is required' and that it 'cannot, or should not commercially, be raised from third-party lenders'. Under this test, the board, acting in its fiduciary capacity, must first conclude that the JVCo *requires* additional funding. The JVA does not define 'required', leaving that determination to the board's business judgment. It is not evident that the board must determine that additional funding is absolutely necessary for the JVCo's survival, such as to cover a funding shortfall for the existing business plan. The board might also determine that additional funding is required for the JVCo to take advantage of a new business opportunity. If the JV parties agree to mandatory capital calls (an option discussed below), they should clarify in art 5.1 just how far the board may go in calling for additional capital to expand the JVCo's business.

Under the test for a capital call, the board must also conclude that third-party debt is not a commercially appropriate method of obtaining the additional funding. Again, this is left to the board's business judgment, and to some degree depends on its options to make calls on the JV parties.

After deciding to make a capital call, which will require considerable due diligence, the board must under art 5.1(a) notify each JV party of the need for additional funding. If each JV party is represented on the board or otherwise actively involved in the financial planning of the JVCo, this notice is merely a formality as the JV parties will already be aware of the situation.

As a default rule, art 5.1(b) directs that the JV parties 'shall ... provide such additional funding by contributions in proportion to their Shares' – with no funding cap. The JVA then sets out two alternative drafting options. The first contemplates a cap on each JV party's obligation to provide additional funding, but still leaves the board discretion to make capital calls within the funding caps. The second alternative provides that no JV party has any obligation to provide additional funding.

Article 5.1(c) affords each JV party preemptive rights to participate in any new share issuances by the JVCo, and, as written in the model JVA, would apply to each of the three alternatives under art 5.1(b).

Article 5.1(d) entitles each JV party to require a fairness opinion from an independent expert on the issue price for new shares. This right is intended to protect against shares being issued either below or above fair value. For example, if shares are issued below fair value, then, to the extent they are not taken up pro rata by the JV parties, those who do purchase (whether JV parties or third-party purchasers) may be paying too little for the shares, and thereby diluting the value of the shares held by JV parties who do not participate. Preemptive rights offer one tool to protect the JV parties against such an outcome. However, a JV party financially unable to participate would still face the risk of value dilution. Likewise, if shares are issued above fair value, then any JV party that participates could be paying too much (unless all JV parties participate proportionately). Nevertheless, obtaining a fairness opinion can be an expensive and time-consuming process, and the conclusions are quite subjective, so the likelihood that it will improve the outcome is unclear. Lawyers drafting or negotiating the JVA may therefore consider omitting art 5.1(d) altogether.

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Richard Keck is a partner in the New York office of Macmillan Keck, Attorneys & Solicitors. He regularly acts for government authorities in designing and implementing competitive tenders, and evaluating applications, for telecom licences, and for project developers and sponsors, and other investors, in forming and negotiating JVAs for bidding consortiums and in connection with the preparation and submission of competitive licence applications. Email: richard@macmillankeck.pro

As an alternative, art. 5.1 offers the drafter the option of simply making all new share issuances subject to unanimous approval by the JV parties. This not only protects each JV party against unplanned capital calls, but also gives each party a veto over funding provided by other JV parties or third parties. Such a provision, while intended to protect any JV party that disapproves of a particular funding option, puts the remaining JV parties at risk of a single hold-out blocking the JVCo from obtaining prudent and necessary corporate finance. Lawyers should thus be wary of including such veto rights, or should at least reduce the risk of a single hold-out, perhaps by replacing the unanimity requirement with a super-majority requirement.

Article 5.2 provides that no JV party is required to give shareholder guarantees for the JVCo's debt, but also sets out parameters on which such guarantees may be provided – namely proportional to equity and, if possible, several and with a right of contribution from other JV parties. As noted in previous instalments, the diversity of interests among the JV parties in a project development JV may require the lawyers to vary from this principle and have certain JV parties give guarantees while others do not.

Article 5.3 allows for additional funding by the JV parties to be in the form of loans rather than equity. Alternative drafting options permit the decision between shareholder debt or equity to be made either by agreement of all the JV parties or by the JVCo's board. Using loans rather than equity may be appealing for tax or other business reasons. Article 5.3 contemplates that the loans will be *pro rata* and on the same terms for all JV parties. Again, in some circumstances, the JV parties may want some, but not all, JV parties to shoulder the financial burden through shareholder loans, although art 5.3 in the model JVA does not contemplate such a scenario.

Article 5.4 requires any JV party otherwise obligated to provide equity or loans to the JVCo under art 5 to pay interest on late payments. This obligation is without prejudice to the other rights of the non-defaulting parties, which will be discussed in future instalments of this series.

In choosing among the drafting alternatives provided in art 5, or in customising them, lawyers should pay close attention to the corporate finance realities likely to be faced by the JVCo and the investment protection and anti-dilution concepts that commonly arise in this context. When entering into the JVA, the JV parties will want to stipulate parameters for capital calls if the funding requirements in the business plan are inadequate. If and when a need for unanticipated funding subsequently arises, the starting point for the JVCo's board is to assess the cost of funds from all potential sources and develop a fundraising plan that maintains an optimal capital structure for the JVCo and JV parties. This could include new debt from third parties (with or without JV party guarantees), new debt from the JV parties, new equity from the JV parties or new investors, or, more likely, a combination of sources.

While the principles of maintaining proportionality and anti-dilution of percentages as reflected in art 5 of the JVA are superficially fair, they are not necessarily realistic or in the best interest of the JV parties. There may also be legal or regulatory constraints. A JV party whose industry expertise was attributed to the JVCo in winning the government contract, concession or licence may be required to maintain a specified minimum percentage of equity in the JVCo. Such party, on the other hand, may also be unwilling to increase its investment in the JVCo beyond that committed in art 4 of the JVA pursuant to the original business plan. This presents contingencies that the lawyers must address.

Some JV parties may want to hold their value but not increase their total investment beyond that committed in art 4, and would rather experience dilution of their percentages. Others may want to increase their investment when the opportunity arises, to maintain or even increase their percentage interest in the JVCo. Changes in relative percentages of equity will, of course, impact relative voting rights in electing directors.

In addition, when its business has matured, the JVCo itself may also be positioned to raise institutional equity in a private placement or even to conduct an initial public offering.

These differing objectives and options require the lawyers to draft the JVA with care and anticipate a wide variety of contingencies. One useful tool, in art 5.1(c), is preemptive rights, where every JV party has a right of first offer to participate pro rata in any new share issuances by the JVCo.

Although not contained in the model JVA, one will sometimes encounter provisions to protect against value dilution. This might arise where future share issuances, other than to existing JV parties on a pro rata basis, are made at a lower price per share than existing JV parties paid for their shares. A value anti-dilution provision might require the JVCo to issue additional shares to existing JV parties in such circumstances to maintain the overall value of their portfolio, but not necessarily their percentage ownership. These provisions (which are commonly sought by later round investors) only work if one or more existing JV parties are willing to absorb the loss of value. For simplicity, preemptive rights are preferable to value anti-dilution provisions as they avoid the 'who shoulders the loss of value' problem. Preemptive rights also allow each JV party to maintain its percentage interest without dilution.

Setting parameters for future capital calls to meet unanticipated funding requirements of the JVCo is a tricky and contentious aspect of drafting and negotiating the JVA, and must be handled with great care and forethought. ■

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