KEY POINTS

- The model Joint Venture Agreement ('JVA')'s blanket approach, without allowing for the varying circumstances under which voluntary transfers are made, is not fit for purpose for a project Joint Venture.
- A pledge to a lender by one JV party (as opposed to a joint pledge to a project lender by all JV parties) may present more issues of concern to the other JV parties than an arm's-length transfer to a third party.
- The model JVA uses the term 'right of first refusal' but actually does not require the transferring JV party to obtain an offer from a third party or even to identify the person to whom it plans to sell the shares.

Feature

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Joint venture agreements: part 13 – voluntary JV party comings and goings

This article is 13th 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 focuses on JVA arts 15 (voluntary share transfers), 16 (entry of new JV parties), 18 (withdrawal of JV parties), 19 (death of a JV party), 20 (change of control of a JV party) and 29 (assignment of JVA rights or obligations). These provisions address changes in the JV parties that originate with the parties who are coming or going as opposed to changes that may be originated or compelled by the other JV parties or the joint venture company ('JVCo').

As noted in prior instalments, the relationship among the JV parties in a project JV is typically specific to each JV party's expected contribution to the JV. Except purely financial investors, each JV party's anticipated contribution reflects its unique experience, market position and other circumstances. Accordingly, the comings and goings of JV parties, unlike changes in shareholders of a listed company, may adversely impact the core reasons the JV was formed. These matters merit care in drafting and negotiating the JVA to avoid later disputes. The lawyers must consider and discuss with their clients a wide variety of scenarios and ensure that the JVA is fit for purpose.

We will first consider voluntary share transfers, which can be subdivided into four potential scenarios:

(i) intra-group transfers between a JV party and its affiliates;
(ii) transfers relating to the sale of a JV party's or its group's entire business;
(iii) pledges by a JV party as collateral for a loan; and
(iv) arm's-length sales to third parties.

Article 15.1 treats all these categories in the same way. It prohibits them unless approved by all the JV parties and does not require any justification for refusal. Optional arts 15.4-15.6 introduce the *additional* (not *alternative*) right of first refusal in favour of the other JV parties. In the author's experience, the appropriateness of transfer restrictions varies for each enumerated situation. The approach adopted in the model JVA, in the case of a project JV, is at the draconian end of the scale. It imposes such broad restrictions on alienability of JVCo shares that in some jurisdictions it may not be legally enforceable.

Article 15.1 also contains a lock-up period during which no JV party may ask to transfer its shares, regardless of context. This provision is unnecessary if unanimous approval is required and there is no duty to justify refusal. However, if the alienability of JVCO shares is less restricted, a lock-up provision can help ensure continuity of ownership during critical early stages in the JVCo's life cycle. As discussed in an earlier instalment, where the JVCo is awarded a government-issued licence, concession or contract, its terms may prohibit the JV party with the experience that was relied upon in awarding the licence, concession or contract from disposing of its JVCo shares for a specified period. Even other JV parties may be restricted from dispositions of JVCo shares without the government authority's consent for an initial period.

The first category to consider includes intra-group transfers between a JV party and its affiliates. As discussed in an earlier instalment, an international group of companies may set up a separate entity to serve as its designated JV party. This may be for tax, regulatory or other valid business reasons. Such a group may need to reorganise in the future, and transfer ownership of its JVCo shares to another group entity. The JVA parties could provide blanket approval for such transfers in advance. Such provisions are common and preferable. Any such transfer, and subsequent transfers of ownership of the transferee, would still be subject to any change of control restrictions (covered by art 20), so an intra-group transfer cannot be used to circumvent restrictions on transfers to third parties. The second subpara of art 15.3 requires the transferee to transfer its JVCo shares back to the original JV party if it ceases to be an affiliate of that party. As drafted, this provision fails to focus on ultimate ownership and instead focuses on affiliation with the original JV party.

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The second situation involves the transfer of JVCo shares in connection with a larger business sale. The ultimate owners of a JV party and its related companies may decide to sell the group's entire business, or that part of the business relevant to the JVCo, to an arm's-length purchaser. They would typically want to transfer the shares of the JV party or its JVCo shares to the purchaser. While such a transfer may have significant implications for the other JV parties, because it represents a change in the ultimate ownership of the relevant JV party, it may be less significant than the stand-alone transfer of only the JV party's JVCo shares. In a sale of the entire relevant business, the characteristics of the JV party that made it an attractive 'partner' to the other JV parties may very well continue following the change in ownership. The seller's JVCo shares may represent the tail of the dog, so such a restriction is unlikely to prevent the overall business sale. If the JV party retained its interest in the JVCo while its owners sold all related business interests to a third party, the remaining JV parties may be worse off than if the sale of the JVCo shares had been permitted because the JV party would no longer have a strategic interest in the JV. The author suggests that such transfers be treated in the same fashion as changes of control of the JV party, discussed below.

The third situation involves the pledge of JVCo shares as collateral. If the JV parties intend to finance the JVCo in part with project debt, then the lenders may require all JV parties to pledge their JVCo shares as part of the collateral for the loan. Those pledges should be expressly permitted. Where, on the other hand, a single JV party and its related companies seek debt financing from lenders who want the JV party to pledge its JVCo shares, the request will need to be considered based on the facts and circumstances. If, for example, the JV party debtor is a vital participant in the JV, and cannot participate without borrowing money, then the other JV parties may want to permit that JV party to pledge its JVCo shares. They may also seek financial representations from the pledging JV party that give them comfort that it is unlikely to default in repaying the loan.

A JV party pledging its JVCo shares typically intends to retain ownership and to remain an active participant in the JVCo. Nevertheless, a pledge to a lender by one JV party (as opposed to a joint pledge to a project lender by all JV parties) may present more issues of concern to the other JV parties than an arm's-length transfer to a third party. If the pledging JV party defaults on the loan, the lender's primary interest will be to recover its losses any way it can, and the lender will not be subject to the same contractual duties to the other JV parties as its borrower. One can easily prohibit such pledges in the JVA, as in art 15.1, but the JV parties may need to enable one or more JV parties to pledge their JVCo shares.

The situation when a pledging JV party defaults on a secured loan typically involves several steps and more uncertainty than an arm's length sale of its JVCo shares. The lender might first acquire the pledged shares in its own name and then to seek a third-party purchaser for them. One risk mitigating technique is to require the lender to offer the pledged shares first to the other JV parties. This reduces the possibility of the lender introducing an unwanted new JV party if the other JV parties are able and willing to acquire the shares. It does not address the loss of the experience or other unique contributions of the defaulting JV party to the JVCo. It is also difficult to price the shares being offered by the lender. Various mechanisms might address this difficulty, but each involves trade-offs between setting a fair price and minimising transactions costs.

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The fourth situation involves an arm's length sale of JVCo shares by an existing JV party. Article 15.1's flat prohibition without unanimous approval is unusually restrictive and is likely to deter financial investors from participating as JV parties. The JV parties may consider requiring the non-transferring JV parties not to unreasonably delay or withhold their required consent. They may also consider having the restrictions end after the JVCo reaches an agreed milestone that signifies its ability to operate independently of the JV parties. In addition, where they desire to control who their 'partners' are, the JV parties may consider having rights of first refusal or first offer (possibly after an initial lock-up period) as an *alternative* to pre-approval.

Article 15.2 requires that a transfer be consummated at the end of a fiscal year. This requirement is unusual and appears neither necessary nor desirable. Nothing inherent in the internal operations of the JVCo will be improved or simplified by allowing only year-end transfers of share ownership. It also unduly restricts the timing of all four categories of share transfers discussed, each of which is driven by external factors that cannot be dictated by the JV.

Article 15.3 requires a transferee of the JVCo's shares to accede to the JVA. This is typical and ensures that the balance of rights and responsibilities struck among the JV parties continues after the transferee acquires JVCo shares. The JVA and the JVCo's constitutional documents should render any share transfer ineffective and void unless and until the transferee assumes the transferor's obligations under the JVA.

The model JVA also includes, in arts 15.4, 15.5 and 15.6, optional provisions for 'rights of first refusal' in favour of the other JV parties as a condition precedent to any transfer of JVCo shares. Such rights are often preferable to flat restrictions on share transfers. The mechanics of the offer and acceptance process, and the pricing of the offered shares, are significant subjects of negotiation. The model JVA uses the term 'right of first refusal' but actually does not require the transferring JV party to obtain an offer from a third party or even to identify the person to whom it plans to sell the shares. Moreover, the price is to be agreed by the buying and selling JV parties or, absent

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agreement, by an independent expert (and JV parties previously accepting the offer may later withdraw their acceptance if they believe the price set by the expert is too high). This is more commonly referred to as a 'right of first offer'.

The model JVA requires the offer to be made to all other JV parties pro rata to their existing ownership of the JVCo, in a round robin until all JV parties have had the opportunity to buy as many available offered shares as they want. If not all offered shares are taken by the remaining JV parties, then the offering JV party may sell the remainder to a third party within a specified period at or above the price set by the expert. A more common formulation of a right of first offer is for the offering JV party to set its own offer price, and then to be prohibited from selling any remaining shares at a lower price. This allows the selling JV party to control the offer price, which would permit a quick sale at a lower price, for example, and in all cases avoid the cost and uncertainty to the JV parties of involving a valuation expert.

A true 'right of first refusal' would typically require the JV party proposing to sell its JVCo shares first to obtain a *bona fide* and binding offer to buy those shares from an arm's-length third party and then to offer the subject shares to the other JV parties on the same terms before selling to the third party. Such provisions, while also relatively common, are usually not realistic as a third party is not likely to invest in making a binding offer only to be forced to wait to see if the other JV parties gazump its offer. Nor is any third party likely to keep its offer open for the period of time required for the internal offer and acceptance process to be completed.

Article 20 addresses changes of control of a JV party. Article 20.1 requires the JV party undergoing a control change to notify the other JV parties. The clause should be strengthened by requiring as much advance notice as possible up to some specified period. Further thought should also be given to the threshold of change that constitutes a change in control. The remaining JV parties have the option under art 20.2 to 'exclude' the JV party that underwent the control change pursuant to art 17 (which is an involuntary buy-out provision discussed in a later instalment). Sometimes a JV party may be impacted by upstream events involving its ultimate owners where the strategic significance of its JVCo shares is relatively immaterial. Between the extremes of the other JV parties simply having to accept the inevitable (which may be unattractive) or of having to buy out the JV party that is undergoing a control change (which may come at a time when they are not in a financial position to do so), there may be other options. One is to allow the remaining JV parties to buy out the JV party undergoing a control change by paying the purchase price in instalments.

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Article 16 addresses the entry of new JV parties by the issuance of additional JVCo shares. This is often used by a JVCo to raise capital to expand its business or meet an unanticipated need. The primary issue, highlighted in art 16, is whether the level of approval required is simple majority, super-majority or unanimity. It is also common to provide preemptive rights for existing JV parties to purchase newly issued shares pro rata or on some other basis. However, where the existing JV parties are not willing to take up the full amount of additional shares offered, or where an additional JV party is required for some strategic reason, then some variation of art 16 regulates the process.

Article 18 addresses the voluntary withdrawal of an existing party. This is a variation on a sale to an arm's-length party and would likely apply where one JV party wants to be excused from its ongoing financial or in-kind commitments to the JVCo. The model JVA offers options ranging from puts, to calls, to third-party sales, to a forced winding up, but the basic premise is that the JV party wanting to withdraw notifies the other JV parties and then a discussion of options ensues, hopefully leading to a mutually acceptable outcome. Such a provision is relatively uncommon. In the author's experience, each JV party commits irrevocably to its required capital contribution, both cash and in-kind, to the JVCo, including all future instalments, and then has a right to sell to an existing JV party or a third party who is willing to assume the unfulfilled obligation, perhaps after an initial lock-up period and subject to any rights of first offer or refusal.

Article 19 addresses death of a party, and is applicable only to individuals, but could easily be adapted to address share transfers by operation of law where a JV party dissolves, is wound up or merges. Due to space limitations, further discussion of the various ways to deal with such situations will not be addressed in this series.

Finally, art 29 provides that no JV party may assign its rights or obligations under the JVA without a corresponding transfer of its JVCo shares and the other required approvals.

In conclusion, the provisions discussed in this instalment deal with the myriad of circumstances in which JV parties may come or go from the JV. As noted, the model JVA's blanket approach, without allowing for the varying circumstances under which voluntary transfers are made, is not fit for purpose for a project JV. The above discussion has offered some common considerations and techniques lawyers for JV parties should bear in mind in drafting and negotiating a JVA for a project joint venture. ■

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