Feature

KEY POINTS

- The model joint venture agreement ('JVA') sets out some, but not all, relevant matters that the JV parties will want to address regarding the JVCo's books and records, accounts, audits and dividend procedures.
- The lawyers for the JV parties would do well, in drafting the JVA provisions for 'counting and distributing the beans', to rearrange them in a more logical order than in the model JVA and to supplement them with the additional provisions discussed in this article.

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Joint venture agreements: part 11: counting and distributing the beans

This article is eleventh 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 10 and 11, which address joint venture company ('JVCo') recordkeeping, accounting, auditing and dividends.[2]

Articles 10 and 11 enable the JV parties to assess the financial performance of the JVCo, account for their respective investments in the JV, and, where appropriate, return profits to the JV parties in the form of dividends. The typical needs of JV parties regarding the JVCo's recordkeeping, accounting, auditing and dividends include the following (which may be a better order in which to cover these matters in the JVA):

(1) to have the JVCo keep sufficient books and records to enable it to conduct its business and prepare necessary accounts (for financial, tax and regulatory purposes) and to enable the JV parties to account for their interests in the JVCo (arts 11.1 and 11.2);

(2) to provide the JV parties with rights of access, inspection, copying and self-auditing of the JVCo's books and records (art 11.5);

(3) to have the JVCo prepare the requisite financial, tax and regulatory accounts for specified periods and at specified dates (arts 11.1 and 11.2);

(4) to provide for appointment of the JVCo's independent auditors and have them test the accounts and confirm that they express a true and fair view of the JVCo's financial position and results of operations (arts 10.1 through 10.3); and

(5) to enable the JVCo to determine the amount of any profits that may be available for distribution to the JV parties, after making adequate provision for contingencies, anticipated capital expenditures and expenses, and to declare a dividend of such distributable profits (arts 11.3 and 11.4).

Articles 10.4 and 10.5, which provide for the appointment of an independent expert, will be discussed in a future instalment on dispute resolution.

The JVCo must, of course, keep adequate books and records. They enable the JVCo to track its business, assess its performance and prepare necessary accounts and reports for financial, tax and regulatory purposes. The model JVA does not set out any affirmative recordkeeping obligations, although they are implicit. Lawyers for the JV parties should consider spelling out with particularity in the JVA the obligation of the JVCo to keep its books and records, and of the JV parties to support that effort. The JVCo's books should record all of the JVCo's assets, liabilities and transactions. Typically, a general ledger is the core document in which all financial transactions are recorded and from which all other accounting information is derived. It should be backed with adequate books and records that document those transactions. The JVA may thus also require the JVCo to keep and maintain adequate records of all contracts, licences, permits, assets, invoices, payments, receipts, bank accounts, legal proceedings and so forth. The JVA might further address how long and where the JVCo's books and records are kept.

If any JV parties perform functions for or on behalf of the JVCo, whether before or after its incorporation, those parties should be obligated to ensure that the records of such transactions make their way into the central repository for the JVCo's books and records. In addition, if one of the JV parties is contracted to manage the affairs of the JVCo under a management agreement, the managing JV party is likely to be required to keep the JVCo's books and records and prepare its accounts as part of that role. Under such circumstances, the management agreement should ensure that the managing JV party complies with all obligations applicable to the JVCo.

The JVCo's books and records also enable the JV parties to account for their investments in the JVCo. Every JV party must account for its investment in the JVCo in some way. Depending on its percentage interest in the JVCo, the applicable accounting standards and other relevant factors, a JV party may be required either to prepare accounts which consolidate the financial position and results of operations of the JVCo with its own (in essence treating the JVCo as a subsidiary) or to account for the JVCo separately as an equity investment. In the case of an equity investment, applicable accounting standards also govern whether, when and how the JV party must adjust from time to time the amount it records on its books and in its own accounts as its equity investment in the JVCo. Such accounting rules are complex and beyond the scope of this series, but the lawyers representing the JV parties must have them in mind when considering the rights and obligations of the JVCo and JV parties concerning the keeping of and access to the JVCo's books and records and the preparation of accounts for the JVCo and the JV parties. Where relevant, lawyers are encouraged to discuss these matters with their clients when drafting and negotiating the JVA.

The model JVA provides in art 11.5 for JV party rights of access to and inspection of the JVCo's books and records. JV parties will require access and inspection rights for their own purposes in the ordinary course of business, such as to obtain data to comply with their own separate financial, regulatory and tax reporting requirements as discussed above. They may also require access and inspection rights for verification or other purposes, as the drafters of art 11.5 of the model JVA appear to have had in mind, such as to verify the financial information of the JVCo if they do not trust the information supplied by JVCo management. The lawyers for the JV parties should consider strengthening the language in art 11.5 to include rights of copying and auditing (by a JV party's auditors at the JV party's expense). Imposing on the JVCo an affirmative obligation, either on request or on a standing basis, to supply certain types of information (in addition to the standard accounts) directly to the JV parties may also be an efficient approach to supporting JV party reporting and accounting requirements. Indeed, with the availability of modern communications, computing and electronic storage facilities, including extranets and shareware, the JV parties might consider providing for real-time electronic access by the JV parties to all or some of the JVCo's books and records. This will enable JV parties to access, download and retrieve any financial information necessary to comply with their own reporting requirements without burdening the JVCo and its staff, and may enable JV parties to address their own requirements more efficiently.

Article 11.1 of the model JVA refers to the preparation of the 'accounts' of the JVCo, presumably referring to standard financial accounts, but does not distinguish between or provide for separate or supplemental financial, tax and regulatory accounts. Apart from supporting the accounting needs of the JV parties as already discussed, a project JVCo typically faces a variety of accounting and reporting requirements, which are not necessarily consistent.

As recognised in the model JVA, the JVCo will need to account for its performance in order to inform the JV parties of how it is performing financially and enable them to make determinations on the payment of dividends. If the JVCo has any debt or other securities issued to persons who are not JV parties, then the JVCo may have financial reporting obligations to such persons arising under contract (such as in affirmative covenants of credit agreements) or by operation of law (such as the duty to supply certain financial information to minority shareholders). The JVCo, even if closely held, may also be required under company or corporate law to prepare and file annual accounts that are made public (such as those required under the UK Companies Acts). In addition, the JVCo may find it necessary or useful to have accounts available for use in obtaining payment terms or other credit from suppliers and other trade creditors as well as for potential large customers or business partners who want to verify the financial condition of the JVCo.

To ensure the JVCo complies with minimum international best practices, lawyers for the JV parties should consider making the JVA more prescriptive about the types and deadlines for its financial accounts. Thus, they might require the JVCo to prepare and deliver to the JV parties periodic balance sheets, income statements and cash flow statements, together with related notes. These are often required on a monthly, quarterly and annual basis, with the annual accounts being those that are audited. The monthly accounts may be due within 30 days after the end of the relevant month, and are typically the most rudimentary. The quarterly accounts may be due within 45 days after the end of the relevant quarter, and are often required to show year-to-date performance as well as for the quarter. The annual accounts are often due within 90 days after year end. These periods may be longer or shorter depending on the needs or desires of the JV parties, what is practical, and any filing requirements imposed on the JVCo by law, regulators or fiscal authorities. Where the JV parties depend on the JVCo's accounts to prepare their own accounts, they may need the final accounts, or working drafts, in advance of their own similar deadlines.

Article 11.2 of the model JVA addresses the JVCo's fiscal year, which is by default the calendar year. This of course assumes that the JVCo will operate in accordance with the Gregorian calendar, so some consideration must be given to other calendars in those jurisdictions that do not follow the Gregorian calendar. The JVCo may need to keep its books and accounts according to two calendars where the calendar followed by the JVCo is different from those followed by the JV parties. The JVA should address such items as the currency or currencies in which the JVCo's books will be kept, and the language or languages in which they will be kept.

The JVA may also address the accounting for pre-incorporation expenses and the JVCo's succession to those items incurred before it was incorporated. The JVA should obligate the JV parties to provide to the JVCo all relevant books, records and other information created for the JV during the pre-incorporation stage.

Under its contract, concession or licence, the JVCo may also have certain regulatory accounting requirements. These are often quite surprisingly different from standard financial accounting requirements. For example, regulated monopolies are often required to treat as capital expenditures certain items that might otherwise be treated as expenses and to depreciate or amortise those items over unusually long periods, all as part of a regulator's way to reduce tariffs or prices. Even where the JVCo does not have a monopoly, the regulator may require it to

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prepare and submit financial accounts and other financial reports in order to monitor the fairness of its pricing, determine its qualification for subsidies (such as universal service subsidies in the telecom market), and monitor whether it is engaging in anti-competitive or discriminatory behaviour.

In addition, the JVCo will typically be a separately taxable entity subject to income tax, gross receipts tax, real property and intangibles taxes, sales, use and value added taxes, excise taxes, import and export duties, and a variety of other taxes relating to employees and contractors. In addition, its distributions and other payments to JV party shareholders, who are likely to be located in other jurisdictions, may be subject to a variety of withholding taxes at different rates depending on the nature of the payment. The JVCo will thus need to keep tax records, prepare and file tax returns and prepare and keep supporting financial statements.

Sometimes, the financial, regulatory or tax accounting rules allow for a particular expense, expenditure, receipt or other financial transaction to be accounted for in more than one manner. Even still, accounting procedures and standards typically require consistency in such treatment over time and across consolidated entities once a reporting entity has elected to treat an item in a particular way. Given the interplay between the JVCo's and the JV parties' accounting for the JVCo's financial transactions, it is customary for a JVA to provide that the JVCo will, where more than one method is permissible, account for such transactions in a way that is consistent with the methods followed by the JV parties (which, of course, may themselves vary from one JV party to the next) or that minimises any adverse financial reporting, regulatory or tax consequences to them. The lawyers for the JV parties should explore these matters with their clients when preparing the JVA, and should ensure that they are adequately addressed. This is especially important for any JV party that is likely to have to account for its investment in the JVCo on a consolidated basis.

The auditing function will primarily support the veracity and accuracy of the JVCo's financial accounting used for shareholder and regulatory purposes. Audits of tax information, on the other hand, are usually undertaken directly by fiscal authorities. Sometimes regulators, vendors, customers and others may also have a statutory or contractual right to conduct their own audits. It is also not unusual for a JVA to allow a JV party to conduct its own audit, at its own cost, of the JVCo's accounts. For basic financial reporting purposes, a clean audit report will state that the auditors have reviewed and tested the JVCo's accounts in accordance with generally accepted auditing standards and believe that the accounts present a true and fair view of the financial condition (assets and liabilities on the balance sheet), income and cash flow of the JVCo at the date of such accounts and for the year then ended. For a start-up JVCo, the auditors may include a qualification as to its ability to operate as a going concern unless it has appropriate financial undertakings by the JV parties to continue funding its needs until it is able to generate positive cash flow.

The model JVA provides in art 10.1 for the shareholders to appoint the auditors, but this can also be a decision to be made by the board of directors. In some jurisdictions, any change of auditors triggers certain reporting obligations to ensure that the change was not made as part of an effort by management to cover up any disagreement over how the JVCo accounts for certain transactions. The lawyers for the JV parties may wish to address the handling of such situations in the JVA.

As noted in earlier instalments, the JVCo may have certain payment obligations to JV parties such as management fees and royalties. The amount of these payments may be based on a percentage of revenues, profits or cash flow or based on some other formula that requires a measure of financial performance metrics of the JVCo. These payments are often keyed to the amounts reflected in the JVCo's periodic accounts, and, where their frequency requires reliance on unaudited interim accounts, a true-up mechanism provides for any adjustments made necessary if the numbers in the annual audited accounts are different from those in the interim accounts.

In addition, the JVCo's payment of dividends may only be made out of profits, and so requires a determination of the profits available for such payments. These matters are addressed in art 11.3. While this provision leaves it to the meeting of shareholders to declare dividends annually based on the audited accounts, the JV parties may prefer that the JVA allows the flexibility of having the JVCo pay quarterly or even monthly dividends, based solely on a determination by the board of directors, particularly if the business plan anticipates that the JVCo will generate a significant stream of positive cash flow and profits following its start-up phase. Otherwise, the model JVA leaves these distributable profits locked up in the JVCo for annual distribution only. The lawyers for the JV parties will also need to make sure the dividend provisions are consistent with local law and any requirements imposed by regulators. The JV parties may want the JVCo to retain some earnings to support budgeted or contingent capital expenditures, operating expenses and other contingencies, but may otherwise want to cash out all excess profits on a regular basis.

In conclusion, the model JVA sets out some, but not all, relevant matters that the JV parties will want to address regarding the JVCo's books and records, accounts, audits and dividend procedures. The lawyers for the JV parties would do well, in drafting the JVA provisions for 'counting and distributing the beans', to rearrange them in a more logical order than in the model JVA and to supplement them with the additional provisions discussed in this article. ■

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

2 This article also recommends omitting art. 12, which provides for JV party leadership in some JVs. As an optional provision, art. 12 of the model JVA allows one JV party to be designated to lead the JVCo. The roles of the JV parties in corporate governance were addressed in previous instalments on the meeting of shareholders and board of directors, and the concept in art 12 is typically not relevant for a project JV.