SPOTLIGHT ON CORPORATE LAW

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JOINT VENTURE

Issues For The Construction Industry

Joint ventures are frequently used in the construction business to bid on and perform contracts for construction projects. A joint venture ("JV") offers a way to combine two or more companies' skills and resources to enable those companies to perform a project that the companies could not perform as well single-handedly.

At the same time, a JV presents the challenge of operating a business with a new partner or partners whose business practices and expectations may be very different. By carefully structuring the JV before any bids are submitted on a project, the participants may be able to avoid the conflicts that often arise in the middle of a project and threaten the ability to complete the project.

WHY CHOOSE A JOINT VENTURE?

By forming a JV, two (or more) contractors can benefit from the particular skills and resources that each has to offer. One participant may have expertise in a particular type of construction, but may need to partner with a company with different expertise to be competitive in a bid process. An out-of-state company may form a JV with a local company who understands the political or business environment of a particular region. Or, the bonding capacity of each participant may be insufficient for a particular project, but the combined bonding capacity of both participants may make the JV eligible to bid on a project.

A JV is usually formed for a specific project, and once the project is completed, the JV is terminated. Therefore, a JV enables parties to join for a specific project, but does not require a long-term commitment to doing business together for any more than the one project.

HOW MAY A JOINT VENTURE BE STRUCTURED?

A JV may be formed by a contract, called a Joint Venture Agreement in most instances, which sets forth the obligations and rights of each participant. This form of JV does not involve the formation of a separate entity, and in most states, the JV formed in this manner is treated as a partnership. As a partnership, the JV does not provide its participants with the protection from liability that is usually afforded to a separate entity. Each participant is jointly and severally liable for all obligations of the JV, and if one participant files for bankruptcy or is unable to meet its obligations, the other participant will be liable for all of the JV's liabilities (not just its share).

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THE JV AGREEMENT

The JV should be governed by a detailed Joint Venture Agreement. A JV means that two companies, each with their own management style, will need to work closely together to complete a project. The participants may believe that their work styles are compatible, but compatibility is never actually known until it is tested by the day-to-day demands of a project.

The JV Agreement must address critical managerial and operational issues, including:

- Who has the authority to make decisions (day-to day operations as well as overall financial management)?

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- How will key project personnel be hired or terminated?
- What resources must each participant contribute or make available?
- What happens if the JV needs more funding than originally anticipated?
- How are profits and losses divided between the participants?
- What happens if one party fails to meet its obligations?

Joint Ventures do not have to be 50/50 – for example, one partner may have a 70% interest and the other a 30% interest, depending on the facts and circumstances of each project and each joint venture, and what each party will bring to the joint venture.

The JV Agreement should cover these primary issues and any other matters that are of particular concern to the participants. No one agreement works for every JV, because participants may decide to structure the JV in any number of ways. The following examples illustrate the many options available to JV participants:

MANAGEMENT

The management provisions in the JV Agreement are particularly important. The goal is to ensure that each participant maintains as much involvement in the JV as it needs to be comfortable with the operations. A participant should not agree to surrender its involvement in JV operations unless that participant has a great deal of confidence in the persons who will be making decisions. On the other hand, the participants should not stifle the JV's operations by requiring that every person be fully briefed on every aspect of the project before any decision may be made.

One participant may be selected to act as the managing party to make all day-to-day decisions relating to the management and operation of the project. The parties may also agree that certain decisions need to have approval of both parties, such as borrowing money, increasing the scope of the project, contract amendments, change orders or making expenditures in excess of a set amount.

Conversely, if both participants want an active role in the operation of the JV, they may form a board of managers comprised of representatives from each participant. The participants may choose an equal number of representatives, or each may elect its representatives to the board of managers based on its percentage interest in the JV.

Joint Ventures do not have to be 50/50 – for example, one partner may have a 70% interest and the other a 30% interest, depending on the facts and circumstances of each project and each joint venture, and what each party will bring to the joint venture. The board of managers may act by majority rule in all instances, or it may require a vote from a representative of each participant (i.e., unanimity) before certain important matters are passed, such as financing applications and the hiring or firing of key personnel.

PERSONNEL ISSUES

Early in the project bid process, the participants should determine whether their own employees will be used for key JV positions (such as project manager) or if new personnel should be engaged. The management provisions of the JV Agreement should specify who is authorized to hire employees, consultants and subcontractors. The participants may authorize the day-to-day decision-makers to hire the majority of JV personnel and subcontractors, although hirings and contracts above a certain dollar amount may require approval of the parties and not just the project manager.

If an employee of one of the participants has a major role in the JV, the JV Agreement should address the ability of the JV to terminate such person. An employee who performs very well for the participant may not do well

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in a new position with the JV, thereby causing awkwardness for all parties involved.

The JV Agreement may include a provision permitting the participant which does not employ the employee to initiate the termination of the other participant's employee, subject to the production of written reports detailing the issues leading to the termination discussion. The ultimate decision to terminate may rest with the JV's highest decision-making body – i.e, the principals of the participants themselves.

CONTRIBUTIONS OF CAPITAL AND RESOURCES

Participants form a JV with the expectation of using the particular resources that each has to offer. The JV Agreement should clearly provide what each party is expected to provide to the JV. If one of the participants is a member of the JV due to its expertise in a particular type of design work, the JV Agreement should state that the responsibility of that participant is to perform all aspects of the project relating to such design work and make available its employees, equipment and general know-how in any way that will assist in the completion of the work. Conversely, a participant brought in solely for its financial resources should not be expected or required to provide specialized construction or other expertise, but it should have its required financial contribution stated in the JV Agreement.

The JV Agreement should also anticipate that the project will require more money and resources than provided in the bid documents. A standard option is to require each participant to contribute its pro rata share of any additional funds. The way in which capital calls are made – including who decides when additional capital is required, how much time each participant has to make the additional capital contribution and the consequences of not making the contribution – should be stated in the Joint Venture Agreement with specificity. Generally speaking, each participant should be given written notice of the obligation to contribute additional capital and a reasonable period of time (such as ten business days) to make such payment to the JV.

In terms of remedies in the event one participant fails to make a capital call, there are a number of different approaches. The JV Agreement may allow the contributing member to contribute capital in place of the other participant, and treat the non-contributing member as in default. The defaulting member is then not permitted to participate in the management of the JV, or receive any distributions from the JV unless and until its capital call default is cured. If not cured within a certain period of time (such as sixty days), the defaulting member's percentage interest in the JV can be diluted.

Alternatively, the contributing participant may elect to treat the additional contribution as a loan to the non-contributing participant (and charge interest on the amount contributed) – again, the defaulting member would not be entitled to receive any distributions unless and until the loan from the contributing member is repaid with interest as provided in the JV Agreement.

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PROFITS AND LOSSES

Generally, profits and losses are allocated pro rata in accordance with each participant's percentage interest in the JV. The participants should decide how and when distributions of profits from the JV will occur. The JV Agreement should provide that the managing body of the JV be permitted to establish and maintain reserves for future contingencies.

How the books and records of the JV will be maintained, and who will be responsible for maintaining the

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books and records should also be stated in the JV Agreement. The Agreement may provide that no distributions to the participants will occur until the project/contract is complete. If the contract/project will extend for a longer period of time, the partners may want to provide for interim distributions on an annual or some other basis. If interim distributions of profits are made, and the JV later needs additional capital, the capital call provisions described above would then apply.

The financial ability of each participant to participate in the JV, and to bear its responsibilities in the event the JV needs capital, is of the utmost importance. For a JV contract/project which lasts for a longer period of time, it is particularly important for each participant to continue to maintain its financial ability to perform as well as provide the other participants with financial information that evidences that continued ability. Remember, if one party is unable to perform, the other JV participant or participants will be required to perform, because their liability to the owner of the project is joint and several.

DEFAULT

Even the most thorough JV Agreement cannot prevent the default of a participant. A JV project is just one of many projects that a participant performs, and major problems in other areas of a participant's business may result in the participant being unable to fulfill its obligations to the JV. The JV Agreement should set forth in detail the obligations of each party and describe the consequences for a party's failure to meet its obligations. Although defaults may not be avoided entirely, the participants' rights and remedies in the event of such default, if specifically stated, may avoid a contentious situation that might otherwise bring a project to a standstill.

If measures such as eliminating voting rights, decreasing ownership interests or delaying the payment of profits during the default are not effective, the JV Agreement may permit one party to buy out the other. A buy-out may not be a viable option with all projects because of bonding requirements and obligations to owners. However, if one participant has sufficient bonding capacity to be the sole obligor under a bond, a buy-out represents a solution to a default. In the event of a participant's bankruptcy, a buy-out may be the only way for the other participant to complete the project and avoid liability under the bond. Buy-out provisions should state the mechanism for determining the value paid to the exiting participant and should specify the timing and method of payment.

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DISPUTE RESOLUTION

Disputes between participants may threaten project completion and may damage the reputation and bonding abilities of both participants. The JV Agreement should provide a mechanism for resolving minor as well as major disputes as they arise (to prevent the dispute from escalating). The participants may require meetings between project personnel to resolve areas of difference. If project personnel cannot reach a solution, management representatives from each participant (who may have little involvement in the JV) may try to reach an agreement.

An outside mediator may be the final decision-maker. In particular, the JV Agreement should establish the timing of the dispute resolution process by clearly stating how long the parties have at each stage to reach a resolution. Otherwise, if the dispute is unresolved for too long, the dispute may interfere with project completion. The JV Agreement also may provide for confidentiality relating to disputes so that the dispute does not come to the attention of the project owner prematurely. In this way, the owner's confidence in the JV will not be unduly questioned.

BANK ACCOUNTS

Participants should also agree on how the JV receives payment, maintains a bank account and makes payments. A common mistake is to provide for a separate JV account, but either not use the account or permit one of the participants to deposit JV funds in its own accounts. Once the JV's money is commingled with a participant's funds, that money may become property of the participant which owns the account. If the participant in possession of the funds files for bankruptcy, the other participant may be called upon to complete the project but may not be entitled to use JV's funds held by the bankrupt participant to pay for the project.

CONCLUSION

In many respects, forming a JV is akin to forming an entirely new business entity to complete one project. The usual business concerns must be addressed, such as bank accounts, payroll and insurance, but the participants need to consider the unique issues presented by two existing companies working closely together. By carefully considering the management of the JV before a project begins, the participants may obtain the benefits of a JV and avoid the pitfalls that may arise in the course of a project. ■

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