MASONS THELEN REID LLP

OCAJI Construction Seminar

MANAGING JOINT VENTURE RISKS ON INTERNATIONAL CONSTRUCTION PROJECTS

Global Infrastructure Lawyers℠

www.masonsthelenreid.com

Overview - Context

- Joint ventures are a common feature in International Construction Projects in Asia.

- There are different reasons to form joint ventures.

- Joint Ventures can take different forms.

- The primary feature that distinguishes a joint venture from a partnership is that the joint venture is usually formed to undertake a single project whereas a partnership creates an ongoing business.

- Proper management of joint ventures, using an appropriate joint venture agreement, is critical in managing the risks inherent in joint ventures.

Overview – Context (Continued)

- Recent experiences of Japanese contractor joint ventures - any possible lessons to be learnt?
- Observations on what makes a joint venture successful

Reasons to Form Joint Ventures

- Taking on a project that is larger than the Contractor would normally undertake, with a view toward spreading the risk.

- Combining two contractors to generate bonding capacity that each contractor would not have, individually.

- Teaming up two contractors with special expertise (a civil and mechanical contractor teaming up to construct a power plant).

- A contractor who has an established organization in a country teams up with a contractor with little or no experience in the country but who offers specialized engineering knowledge or skill.

- A foreign contractor teaming up with a local contractor who may have political or other valuable relationships in the local country.

Types of Joint Ventures

- Integrated Joint Venture
  - Primary characteristic is that it can represent a true partnership, in that the parties share profits and losses.
  - The interest may be 50% - 50% or some other division, and there may be 2 or more Members.
  - The Members share the profits and losses in proportion to their interest in the Joint Venture.
  - The Parties combine resources and personnel in an agreed upon manner.

- Typically used
  - Strong, lengthy relationship between parties
  - Non-linear, complex projects
  - To spread risk on large projects

Types of Joint Ventures (Continued)

- Non-Integrated Joint Ventures
  - Primary characteristic is that it is NOT a partnership, in that there is no sharing of profits and losses.
  - Each Member takes on a specified scope of work, and is responsible for the profits or losses associated with that scope of work.
  - Each Member is solely responsible for the resources necessary to perform their specified scope of work.
- Typically used
  - Limited relationship wanted between parties
  - Linear projects with distinct work scopes

Types of Joint Ventures (Continued)

- Combination Joint Ventures
  - They present a combination of an Integrated and Non-Integrated Joint Venture.
  - Each Member takes on a specified scope of work, and is responsible for the profits or losses associated with that scope of work.
  - But the Members also agree to act as partners with respect to a portion of the necessary work, which may include sharing the preliminaries and general conditions necessary for each Member's separate scope of work, as well as the actual performance of a portion of the work of the project.
- Typically used
  - Becoming popular, reflects more closely the likely spread of specialist as well as general work required on the larger more complex projects.

Key Terms in Joint Venture Agreement

- The joint venture agreement on a sophisticated international construction project is a complex document that is usually the product of extensive negotiations between the parties.

- A typical joint venture agreement will include over 30 numbered paragraphs and many sub-paragraphs.

- It is not possible in this seminar to review ALL of the important provisions that go into a proper joint venture agreement.

- We can, however, review some of the key features of Joint Venture Agreements.

Management of Joint Ventures

- A unique feature of the Joint Venture is that it needs to be managed with due attention to the sometimes divergent interests of the members.
- While the Joint Venture is not a partnership (usually the JV Agreement will expressly stipulate that it is not), its structure and form closely resemble a partnership.
- Frequently the Joint Venture will, like many partnerships, include only two members. This can lead to tie votes and impasses.
- In managing the two member Joint Venture, a mechanism is needed to break the ties that develop.
- And in any event, there must be a manager of the Joint Venture and the Joint Venture must have a decision making structure.

Management Board

- In order to avoid one party dominating the joint venture, it is a good practice to establish an appropriate system of management.
- Management will normally be in two tiers; project level and "board" level.
- The top layer is often referred to as the Management Board.
    - Its members usually include senior management personnel from the head offices of the respective members, and NOT project staff.
    - The Management Board is usually empowered to take such actions as appointing the Project Manager and taking action on any matters which cannot be resolved at or delegated to the Project level.

Management Board (Continued)

- There are several different ways to manage the decision making process at the Management Board level.
- Require unanimous consent on any vote, with the matter being submitted to a dispute process in the event that agreement cannot be reached.
  - This is not a particularly good approach, as there may be critical matters on which decisions need to be made for which delays can prove to be damaging.

Management Board (Continued)

- Require unanimous consent but in the event unanimity cannot be reached, include a tie-breaking mechanism.
- The JV Agreement should provide that the person who is to make the final decision shall act in a way that benefits the interests of the joint venture as a whole, as opposed to any one of its individual members.

Project Level Management

- The project level management is often left to a project manager with or without the support of a project board.
  - Any project board will usually include key project personnel.
  - The chairman of the board is usually the project manager.
  - The project manager is usually selected by the management board, but frequently the terms of the joint venture agreement will prescribe who may be nominated as the "Leader" of the JV and as such may be empowered to select the project manager and/or his deputy.
  - Generally, unanimity is not required of the Project Committee, and frequently the Project Manager will be given the right to break tie votes.

Project Level Management (Continued)

- The project manager and project board will essentially conduct the day to day business of the JV
  - open and manage the bank account;
  - submit the monthly payment applications and interact with the Engineer and the Employer;
  - submit and negotiate change orders;
  - approve and manage subcontracts and purchase orders;
  - manage work progress

Project Leader

- The concept of the "Leader" takes into account the fact that one of the joint venture parties will have to be in a position of negotiating with the employer and/or other third parties.

- This will be the case even where there is an non-integrated joint venture where each party is undertaking its own separate scope of work.

- Therefore, it is critical that all joint venture agreements contain provisions that EITHER: (1) specifies the party that is the "Leader" of the JV; OR (2) identifies who is the project manager or a mechanism to appoint the project manager.

- In any event, the role and powers (authority) of the "Leader" or the "Project Manager" need to be defined.

Working Capital

- Regardless of whether the joint venture is an integrated or non-integrated joint venture, provisions must be included that address the responsibility of the parties for working capital contributions.

- Working capital will obviously be required at the commencement of the project and, perhaps, at times during the performance of the Works.

- Failure to contribute necessary working capital can have disastrous results to the Joint Venture.

Working Capital (Continued)

- Likewise, given the importance of working capital contributions, the joint venture agreement must specify the consequences of the failure to make required working capital contributions.

- Generally, the failure to make working capital contributions is NOT considered an event of default justifying termination of the interest of the party who has failed to make the additional working capital contribution, although it can be treated as such.

- The more common way to treat the failure to make working capital contributions is to allow one member to contribute the amount that the other member failed to contribute, and to adjust the interests of the members in the PROFITS (but not the losses) accordingly.

Default

- Another key item to address in any joint venture agreement, as in any main contract or subcontract, is the default of one of the members.
- Default must be defined, and remedies for default included.
- Often cross indemnity clauses and parent company guarantees to establish liability and in turn security.
- The most serious type of default is insolvency of one of the Members.

Default - Insolvency

- The power of the non-insolvent joint venture members to take action with respect to the insolvent members interest in the joint venture may be subject to the bankruptcy law of the jurisdiction in which the project is pending or in which the bankruptcy was declared.
- Local bankruptcy law may provide that the insolvent member's interest in the joint venture is an asset of the estate of the bankrupt member, and that any provisions that purport to forfeit the member's interest in the joint venture as a result of the bankruptcy are invalid.
- For this reason, it is recommended that the joint venture agreement respond to the insolvency of a member by providing that the insolvency removes the insolvent member from any voting or decision making power in the joint venture, and that the insolvent member's interest in the joint venture shall be determined when the affairs of the joint venture are concluded.

Recent Experiences

- Highly competitive international construction market has put strains on joint venture relationships
- Japanese joint ventures – disputes even amongst Japanese business community
- International joint ventures – cultural issues/attitudes and risk of misunderstandings
- Impact of such issues on relations with advisors, employers and subcontractors/suppliers

Recent Experiences (Continued)

- Use of joint venture agreements to establish further "lines of liability"
- Joint and several liability at main contract level – in effect guaranteeing the performance of others
- Loss of control of project process in favour of a project leader – removal from influential role in resolving claims/disputes

Successful Joint Ventures

- Use of long term partners – familiarity and awareness of cultural/business issues
- Due diligence on joint venture members – ensure solid on both technical and business grounds
- Small project to start
- Use of comprehensive joint venture agreement

Successful Joint Ventures (Continued)

- Recognition of management control issues – in effect recognising the need to release control but on appropriate terms
- Avoid taking on main contract liability while becoming in effect a subcontractor
- Seek security for members liability and responsibility
- Transparency in provisions dealing with project leadership and delegation of duties to project manager

MASONS THELEN REID LLP

Global Legal Infrastructure Services from Masons and Thelen Reid & Priest LLP

LONDON
T +44 (0) 20 7490 6230
F +44 (0) 20 7490 6676

SAN FRANCISCO
T +415 371 1200
F +415 371 1211

SHANGHAI
T +86 21 6321 1166
F +86 21 6329 2696

MADRID
T +34 91 436 33 25
F +34 91 436 33 29

NEW YORK
T +212 603 2000
F +212 603 2001

HONG KONG
T +852 2521 5621
F +852 2845 2956

EDINBURGH
T +44 (0) 131 225 0000
F +44 (0) 131 225 0099

WASHINGTON, DC
T +202 508 4000
F +202 508 4321

866303

Global Infrastructure Lawyers[SM]

www.masonsthelenreid.com