QUEEN - CITY - LAW

BARRISTERS & SOLICITORS

JOINT VENTURE AGREEMENTS

QUEEN CITY LAW (MARCUS BEVERIDGE)
Marcus@queencitylaw.co.nz
AUCKLAND, NEW ZEALAND
P O BOX 6908, WELLESLEY STREET
DX CP24080
TELEPHONE 0-9-970 8810
FACSIMILE 0-9-970 8820

173954_1

JOINT VENTURE AGREEMENTS

A. INTRODUCTION

1. *DEFINITION OF JOINT VENTURE*

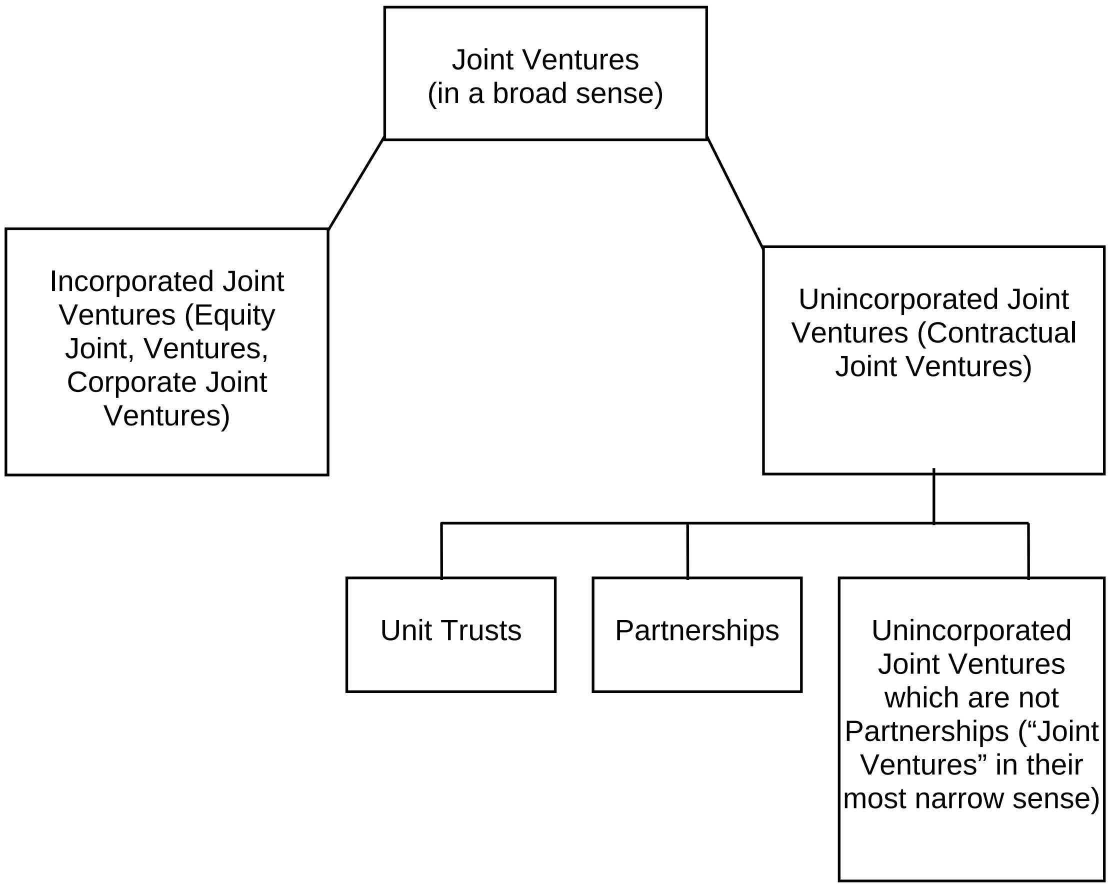
- The term "joint venture" is one of art, not law. The term itself is very vague and does not describe the actual structure adopted or even the objectives of the parties forming the association. It merely suggests that each of the investors are to a greater or lesser extent active rather than passive participants and will make contributions to the venture in a variety of forms beyond their equity subscriptions.
- Likewise, there is no law of joint ventures as such and this area usually involves a mix of contract and corporate law and in some cases concepts from partnership, equity or agency law.
- Examples of joint venture relationships include mining or exploration agreements (involving an investor and an operator), investment arrangements (ie involving a capital investor and an existing trading company), co suppliers which require greater size to be competitive and gain economies of scale etc.

2. *BUSINESS RATIONALE*

Joint ventures have become widely used by companies to gain the following competitive and strategic benefits:

- It is a means of implementing changes to a company's strategic position and spreading its financial risk - ie by allowing it to concentrate on its areas of relative competence while diversifying into unfamiliar business areas.
- However it may also allow a company to deal with business opportunities in its core area of competence which are too big for it. Therefore joint venture entities can cope with large contracts and gain economies of scale.
- It also allows international investors to acquire local knowledge and contacts by entering a joint venture with a local entity.
- In contrast to using a company or partnership structure, a joint venture is seen as having advantages in terms of greater flexibility. Parties are free from many of the restrictions under the partnerships and companies acts. Also, as opposed to a partnership, a joint venture structure gives each party a 'limited' liability in the sense that each party is severally liable (and not jointly liable) for its share of monies owing to third parties.
- Each joint venturer can adopt its own accounting treatment of its interest in the joint venture.

3. *DIFFERENT TYPES OF JOINT VENTURES*



4. *HOW DO THEY DIFFER FROM OTHER RELATIONSHIPS*

From a practical perspective, there are essentially two questions to consider when determining the nature of a particular joint venture relationship:

- Is there a partnership?
- If not, is there sufficient "mutual confidence and reliance" placed in either party to create fiduciary obligations between the parties?

<u>Partnership</u>

This is an important question to determine because if there is a partnership, the parties are jointly liable to third parties, each partner is able to bind the others and they will owe each other fiduciary obligations.

Broadly, a partnership is defined as "the relationship which subsists between persons carrying on a business in common with a view to profit". The key difference in concept between a partnership and a joint venture is that in a joint venture, the parties both put in assets, have separate interests in these assets and continue to carry on separate businesses. In a partnership, the businesses of the parties merge and are run in common. Also, Partners don't have separate interests in the assets (only a chose in action).

There are two approaches to determining whether the relationship is a partnership: 'dissectional approach' and the 'overall approach'. Both will be considered.

Dissectional Approach

The Partnership Act sets out certain specific criteria and a lawyer trying to ensure that the relationship falls outside the Act must consider the following questions:

1. **The real intentions of the parties** - Whether there is a partnership or not will depend on the contract terms and the course of dealings between the parties. In most joint ventures there will be no intention to form a partnership (see below).
2. **Do the parties deny a partnership** - a negating provision is relevant but not decisive. If a partnership does in fact exist (based on the terms and course of dealings) then this type of provision will have no effect.
3. **Is the business carried on in common** - In partnerships, the partners generally manage the business. However in joint ventures, an operator is usually interposed to run the business.
4. **Sharing of profits** - this is an indicator (but not conclusive evidence) of partnership.
5. **Who has management control** - it is common for a financial institution to provide equity capital to an entrepreneur and the existence of a partnership may depend on the degree of control they take. Usually the threshold is whether the degree of management control is greater than that needed to protect the money.

Overall Approach

This technique compares core aspects of partnerships with that of the specific joint venture and helps to determine the intentions of the parties. The following aspects of joint ventures conflict with traditional partnerships:

1. The joint venture agreement is expressed to create a joint venture and not a partnership.
2. The agreement provides that joint venturers cannot bind each other. This contrasts with partnerships where every partner is the agent of the firm.
3. The agreement provides that joint venturers are severally liable only in their proportionate interests for debts of the joint venture. This contrasts with partnerships where partners are jointly liable for the debts of the firm.
4. The agreement provides that the joint venturers hold the assets of the joint venture as tenants in common in undivided shares. This contrasts with the interest of a partner in partnership assets which is a chose in action (ie a personal as opposed to a proprietary interest).

Key Points

- Main question is what are the real intentions of the parties as evidenced by the agreement and course of dealing.
- This area is very much a question of fact depending on the particular circumstances and so careful consideration must be given to each case.
- A partnership attracts the full range of fiduciary duties, the provisions of the Partnership Act and each party will be jointly liable to third parties.

Fiduciary Obligations

In terms of obligations owed between parties to an unincorporated joint venture, it is best to think of a continuum of possible relationships ranging from partnership on the one hand to a straight commercial arms length transaction on the other. Courts may find different degrees of fiduciary duties along that continuum.

Therefore:

- Contractual relations and fiduciary obligations can co-exist.
- Courts are reluctant to find fiduciary obligations in a commercial, arms length transaction with parties of equal strength where the parties' obligations are fully set out in the agreement. Fiduciary duties will only exist where they are consistent with and necessary for giving effect to the relationship (*Auag Resources Ltd* [1994] 3NZLR 571).
- Although the Courts have left the question open (depending on the particular circumstances), the general test is whether sufficient confidence or reliance has been placed in the skill, knowledge and integrity of each party to attract fiduciary duties.

What do fiduciary duties entail?

- A party must not use its position to gain an unauthorised profit or advantage for itself (profit rule) **or**
- Must not enter into a conflicting arrangement (conflict rule)
- As mentioned, the degree and nature of these duties will depend on the relationship and the terms of the joint venture agreement.
- Fiduciary duties may be owed in respect of certain parts of the relationship only (*NZ Netherlands Society* [1973] 2NZLR 163).

5. *KEY ISSUES FOR INCLUSION UNDER A JOINT VENTURE*

1. Broad scope of the joint venture (ie purpose and objects).
2. Hold assets as tenants in common and specify percentages (ie the separate property of each party).
3. Usually agree on a three tier decision making process:
    - matters affecting their basic rights or obligations are referred back to the parties and require mutual agreement before any change
    - major matters which relate to the policy or running of the joint venture are referred to a management group comprising representatives of each (whether a resolution is required to be unanimous or say two-thirds will depend on the particular subject matter)
    - manager operates the project as agent for the parties and therefore makes decisions up to a certain expenditure threshold or of a certain nature.
4. Agree to bear all costs of the joint venture in proportion to the respective interests (usually).

5. Each party is responsible for obtaining its own share of the monies needed to meet the joint venture costs - substantial joint borrowings to fund the venture are unusual.

6. Parties may only with all the other party's approval grant a charge over their share to other parties to secure their obligations if a disparity in financial strength.

7. Parties agree to act in good faith to each other either generally or in respect of certain specified matters.

8. Parties agree on procedure to be followed if one party wanted to sell or assign its interest. Usually pre-emptive rights.

9. Agree to the remedies available against a defaulting party.

10. Each party usually given a share of the profits or production in proportion to its interest in the joint venture. They may deal with this separately.

11. Parties agree that their agreement does not constitute a partnership nor create an agency inter se and their obligations are several and not joint.

12. Other matters including budgets, confidentiality, governing law, settlement of disputes, termination, force majeure, notices etc. - usual general contract clauses.

As the above suggests, joint ventures are often lengthy and complex documents in which the parties set out all their rights and obligations inter se in relation to the joint venture.

6. *LEGISLATIVE AND REGULATORY INTERVENTION*

Apart from the Partnership Act (which may or may not apply), the two regulatory regimes which are likely to affect joint ventures are the Commerce Act and the Companies Act. The provisions of the Companies Act will be dealt with later under incorporated joint ventures.

<u>Commerce Act</u>

The Commerce Act may have implications in the following situations:

- **Anticompetitive provisions** - In respect of a joint venture between competitors problems may arise with agreements which contain provisions which may have the effect of lessening competition in a market (for example, provisions which restrict the ability of participants to compete with the joint venture or restrict the scope of the joint venture from its potential range of activities (territory, output etc)).

  However the Act specifically recognises the phenomenon of joint ventures and states that the prohibition on price fixing will not apply to the price for goods or services jointly supplied under the joint venture (section 31).

- **Mergers** - Section 47 of the Act covers business acquisitions. Competitors using a 50/50 joint venture company will not be successful in avoiding these provisions.

- Section 47 provides that, where two or more persons are "interconnected or associated" and together are in a dominant position, each of them is deemed to be in a dominant position in that market.
- "Interconnected" is defined as being the test of a subsidiary under the Companies Act 1993 (ie over 50% of equity securities or control of the Board). On this test, in a 50/50 joint venture, neither shareholder is interconnected to the joint venture company since they do not own or control more than half of the issued shares nor exercise over 50% of board control.
- However, "associated" is defined as being able to exert a substantial degree of influence (which in this context means great or large) over another party. In the Commerce Commission's guidelines a 20% shareholding is prima facie evidence of this.
- In relation to determining whether the shareholders themselves are associated, the Commission will consider joint venture agreements between the parties as being relevant.
- In addition, the joint venture agreement that establishes this arrangement may be challenged as being likely to lessen competition in a market (sections 27-29).

B. TYPES OF JOINT VENTURES - INCORPORATED VERSUS UNINCORPORATED

1. *ADVANTAGES AND DISADVANTAGES OF EACH STRUCTURE*

The exact nature of the joint venture activity and the objectives of the parties will have a substantial bearing on the choice of structure, but the following factors will be relevant:

- **Privacy** - an unincorporated joint venture agreement is a private arrangement and therefore is not subject to public scrutiny like the constitution of an incorporated company.
- **Familiarity** - the nature of the business or the attitude of one or more parties may lead to a choice of incorporated entity. The framework provided by corporate law and protection available to shareholders may be preferred in practice as an additional safeguard to contractual rights.
- **Accounting flexibility**- partners may prefer an unincorporated venture allowing them to keep separate accounts and maintain their own accounting policies.
- **Transfer of interests** - it is easier to transfer shares to incoming parties which is a big advantage of an incorporated joint venture. Because it tends to be specific as to the parties needs, a transfer of shares is unusual once the joint venture is fully operational.
- **Financing** - if the parties want to use collective financing and grant security over the joint venture assets, a company can be an advantage. Also, partly paid up shares can be issued as a way of securing further capital.
- **Fiduciary relationships** - shareholders within an incorporated joint venture would not ordinarily have concern unless special provisions are inserted into the joint venture agreement.

2. *ELEMENTS OF DIFFERENCE BETWEEN THE TWO STRUCTURALLY AND PROCEDURALLY*

The main difference between the two is that in an unincorporated joint venture, the shareholders agreement sets out the entire agreement between the parties whereas in an incorporated joint venture, the shareholders agreement sets out the detail of the agreement and also establishes the structure and process of setting up the joint venture vehicle and the basis on which it will operate.

C. CONTENTS OF JOINT VENTURE AGREEMENT

Elements common to both incorporated and unincorporated joint ventures.

1. Statement of joint venture activity and objectives

   - This usually lists the general objects of the venture with some degree of detail (may refer to a schedule for more detail).
   - Also usually states that the benefits of wealth creation will be shared in the joint venture by the shareholders of venturers proportionate to their holding.
   - The shareholders agreement will usually contain a provision that the parties will exercise their powers so as to achieve these objectives.

2. Conditions to Agreement

   - For unincorporated joint ventures examples include:
     - regulatory consents
     - all licences required
     - approval of business plans
     - parent boards approval.

3. Term of Venture

   - The usual events of termination include by agreement, appointment of a receiver or liquidator.
   - However depending on the circumstances they may also include:

     (a) an investor's equity ownership falling below a certain threshold, listing on a stock exchange, completion of the specific project or a specified date.

4. Raising of initial and continuing capital

   - Where a joint venture company is envisaged, the start up capital will usually be provided by equity capital (ie subscription for shares). The agreement will set out the number, class, price and other terms of the shares to be taken by the parties. This may be complemented with loan finance.
   - The subsequent raising of capital for the venture will be set out in the agreement and in the case of a company may involve agreement between the parties to issue and subscribe for new shares or put in additional finance as agreed in proportion to their interests in the venture in the case of an

unincorporated joint venture. If one party cannot put fresh capital up, the other party may put in more in return for dilution of the other's share (usually where parties have unequal resources).

5. Ownership of interests and profit share

- In an unincorporated joint venture the venture property is beneficially owned by the parties as tenants in common in proportion to their interests. This may be in equal shares or in different percentages.
- Likewise, the profits and losses of the parties will be shared in proportion to their respective interests.
- Sometimes in an unincorporated joint venture a company is set up to own the assets so that when these are sold, depreciation claw back and stamp duty are not incurred.
- The most likely risks are either trading risks or, if fiduciary duties are owed, joint liability for the other party's debts.
- Method of dealing with this is to set up sole purpose subsidiaries to be the joint venturers. This quarantines the risk (although the holding company may be deemed to be a director for the purpose of management decisions). Indemnities are also commonly sought from each party if they go outside their authority under the agreement.
- Under an incorporated joint venture, the company itself owns the assets and the profits of the company are shared by the shareholders in proportion to their shares. The agreement will set out the minimum dividend policy of the company (ie 30% of profit after tax).
- A common tension is between one party wanting to poor profits back into the venture while the other wants to remove the profits (ie Japanese venturers have traditionally been in these arrangements for the long term).

6. Auditors

- The Agreement will usually specify independent auditors which act as experts and not arbitrators. This is required because of the potentially conflicting interests of the joint venture parties on financial matters. Each party will want to reserve its position in relation to the decision of the auditors.

7. Manager and review of Manager

- The agreement depending on the circumstances may allow for the appointment of a manger who will be responsible to the day to day running of the venture and will report to the management committee of an unincorporated joint venture.
- One structure is the venture forming or contracting these duties to a separate management company which provides an indemnity to the venturers in the case that it goes outside the bounds of its contract.
- The manager will usually be required to:
  - submit project and financial reports to a management committee on a continuing basis
  - be subject to periodic review by the management committee (eg on a monthly basis)

- be required to get management committee approval for expenditure amounts above a certain threshold.

8. Structure of management committee or board of directors - decision making

- The structure of a management committee (unincorporated) and the board of directors (incorporated) are similar and can be dealt with together.
- Structure - each party will usually have the ability to appoint representatives in proportion to their interest in the venture (ie usually 50/50).
- Quorum - there will usually be a requirement that at least one representative from each party is present and voting may be either by majority or unanimous approval. However the latter option gives each party a right to veto any decisions and may cause deadlock (see below).
- The agreement will usually provide for the usual notice requirements for meetings of boards of directors.
- Although there are many variations, certain key matters will usually require unanimous resolution of either the directors or shareholders or the management committee. Such matters include:
  - issue of new shares
  - expenditure over certain thresholds
  - acquisitions or divestments
  - amendment to the agreement (or any supporting agreements)
  - dividend payments.

9. Partnership provisions

- Useful but not decisive.

10. Financial information

- Depending on the degree of monitoring or control which the parties intend to take, the agreement may require the provision of monthly or quarterly financial information as well as the annual accounts.

11. Confidentiality

- Usual considerations apply (eg accurately defining the confidential information, positive obligations of parenting disclosure during and after the agreement).

12. Dispute Resolution

- Some believe that silence in the agreement is the best solution as it forces parties to come to a commercial solution. Prevents the business from being run down while lengthy processes are put in motion. However, in this case court proceedings may be used by a stronger party to gain an advantage.
- Alternatives are appointing experts, mediators or arbitrators. The latter option is potentially expensive and time consuming although comparatively better than court in this respect.
- May be better to use some form of deadlock breaking provisions such as the following:
  - swing man director (ie leaving a director position empty until deadlock in which case shareholders may then vote to fill this position)

- shot gun provisions which forces either party to either sell or purchase the shares from the other party. The price for the shares is usually set in accordance with a formula in the agreement.
- Auction system - where all the shares are put up for auction and the bidders are the shareholders themselves.

13. Restraint of Trade

- A contractual covenant in restraint of trade is enforceable if:

  (a) The covenantee has a legitimate interest (of a proprietary nature) which is entitled to protection; and

  (b) The covenant is no wider than what is reasonably necessary to protect relevant interest of the covenants.

- Where the Courts have upheld covenants restrictive of competition they have tended to be reasonably necessary to render that transaction, contract, or arrangement effective.

- In *Dawnay Day & Co Limited v De Braconier D'Alphen & Ors* the English Court of Appeal held that a restrictive covenant in a joint venture agreement, drafted to apply for two years from the date of the agreement and for a period of one year following the defendants' termination, was enforceable.

- In assessing the reasonableness of a restraint the Courts give weight to the fact that the commercial parties were well able to judge where their reasonable commercial interests lay.

14. Good faith obligations

- The key issue is what "good faith" means.
- Authority and opinion is divided on whether this means to act in the best interest of all parties (ie not in their own interests) or whether it is not to act in bad faith.
- The sensible approach seems to be that they must act in the interests of the other parties but not to the exclusion of their own interests.

Elements specific to incorporated joint venture

1. Structure of joint venture company

- The agreement will set out the name of the company, the ultimate shareholding structure (ie number and class of shares), price and proportion of shares taken by each party.
- The agreement will also specify that the parties will enter into a constitution consistent with the terms of the shareholders agreement - a copy will often be annexed.

2. Pre-emptive rights on issue or transfer of shares

- This is the most fundamental provision of an incorporated joint venture agreement.
- Issues of shares will usually require the consent of all shareholders. New shares will be offered to the shareholders pro-rata on a pre-emptive basis.
- On the transfer of shares pre-emptive rights will also apply. These may restrict a shareholder to selling all of its shares, or in the event that it may sell any part of its shareholding, may have a provision requiring it to sell the balance of its shares to the remaining shareholders if its holding falls below a certain percentage.

3. Exercise of shareholder approval

- A number of key business decisions will require up to 100% approval of shareholders (see earlier management decision making).

D. ADDITIONAL DOCUMENTS ENVISAGED BY A SHAREHOLDERS AGREEMENT

1. Management Agreement.
2. Deeds of Guarantee and Indemnity.
3. Financing Agreement.
4. Technical services agreement.
5. Brand Licence agreement.

E. CONSTITUTION OF JOINT VENTURE COMPANY

1. Designed to give effect to shareholders agreement within corporate context.
2. Relationship with joint venture agreement - the common law principle is that in the event of inconsistency, the constitution will override the joint venture agreement. However, it is common practice to include in the joint venture agreement and constitution a provision which states that any obligations of shareholders set out in the constitution will be subject to any shareholders agreement entered into between the shareholders and prevailing from time to time.
3. Although there are many ways of doing this a technique we have used is to prepare a relatively standard form of constitution with the following provisions:

- certain key variations within the main body of the constitution. These will usually include to pre-emptive rights on issues and transfers of shares, board structure and decision making; and

- include a general overriding clause which may contain the following:

  (a) make the other provisions of the constitution subject to this provision in the case of any inconsistency;

  (b) make the exercise of powers by directors subject to shareholders' agreement;

  (c) specify the exact composition of the board; and

  (d) state that no new shares be issued without the consent of all the shareholders.

- Alternatively, all these matters may be drafted into the main body of the constitution.

4. *Companies Act 1993*

The new companies legislation has increased recognition of joint ventures and allows parties to make specific provision for them in the constitution in the following areas:

- Section 131(4) - directors are able to vote in the interests of their appointing shareholder.
- Section 145(2) - directors may disclose information to its appointer unless prohibited to do so.
- Minority Oppression Rights.