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Key Factors when Considering to Joint Venture

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KEY FACTORS WHEN CONSIDERING WHETHER TO JOINT VENTURE

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Finding the right fit with a joint venture partner is crucial to the success of a construction project. As mega-projects continue to increase, not only in size but also in popularity, contractors will be looking to form joint ventures to pursue and complete such projects. The pooling of capital, resources, capacity, and expertise to meet the demands of mega-projects and successfully complete such projects are the driving motivators for contractor teaming.

A. Factors to Consider in Finding the Right Fit.

a. Capital

The pursuit of mega-projects can be expensive, especially for design-build projects which typically include preliminary design fees paid to the designer for the pursuit phase. In a joint venture, contractors share all third-party pursuit costs and reduce the number of personnel working on the bid thereby reducing internal bid phase costs. Post-award, the contractors each contribute their share of the initial working capital necessary to start the project. By sharing these costs for equipment and materials purchases, the contractors are able to reduce their individual capital outlay. Finally, the risk of loss is shared proportionately by the partners per their percentage shares, so that in the event of a loss on the project, the respective hit to each partner's balance sheet is lessened.

b. Resources

Industry-wide, contractors are struggling to employ sufficient personnel – both at management and labor levels – and this problem is not expected to improve anytime soon. In fact, it will likely get worse. By joint venturing, the strain on contractor personnel for each firm is reduced, which is particularly beneficial on projects with long durations. The JV relationships may also benefit from each individual party's relationship with the owner, knowledge of the regional subcontractor market, local unions and the local labor pool. The JV will also benefit from the contribution of partner-owned equipment. When preparing the proposal, each JV contractor oftentimes prepares an independent estimate of project costs. This allows the parties to conduct an intensive comparison to sharpen their price and avoid any cost oversights.

c. Capacity

Each year, mega-projects are increasing in size, complexity and number – often with contract values in the multiple billions of dollars. Many contractors, even the largest U.S. and international firms, need to team on these mega-projects in order to meet the project's bonding requirements. Bid bonds or surety letters confirming sufficient bonding capacity are typically required. In a JV, the partners each contribute bonding capacity equal to their percentage shares in the JV. Although some sureties use the full contract value as the amount reducing a contractor's surety program capacity, some sureties only reduce a JV contractor's bonding capacity based on its percentage interest in the joint venture, thereby "freeing up" capacity for other projects.

d. Expertise

Another reason contractors may choose to joint venture is to benefit from the combination of their areas of expertise, thereby improving their "score" with respect to the qualifications and experience proposal evaluation. For example, depending on the type of project, large civil contractors may team with a rail transit contractor, a utility contractor or a bridge contractor to bolster the team's experience levels, technical expertise and likelihood of a successful bid. Contractors may also decide to joint venture to expand their business into a new sector, such as data centers. In order to add data center projects to its resume, a contractor may need to team with one that already has such experience to be selected to complete that first data center project. The experienced data center contractor may be motivated to team with the inexperienced contractor to assist with capital requirements, resources or bonding capacity, as discussed above. One additional reason for forming joint ventures has been to achieve the owner's disadvantaged business enterprise (DBE) requirements by creating a team with one or more DBEs whose percentage ownership interests in the JV help meet or exceed the owner's DBE percentage goals or requirements. Even if requirements for DBE participation decrease on some public projects in the near future, the DBE's expertise and/or owner and subcontractor relationships will remain as strong incentives for teaming.

B. Due Diligence

Once the determination to joint venture is made, a contractor needs to conduct "due diligence" in selecting the right partner for the project. Evaluating a contractor's capital and capacity requires the exchange of financial statements (at least the last three years), WIP schedules, and current bonding capacity by both partners. If applicable, a contractor's willingness to provide a parent company guarantee to its JV partner should also be considered. Equally important is examining the potential partner's resources and experience. Both parties must be able to commit to providing the required capital, equipment and personnel – especially key personnel – for the life of the project. Further, conducting a detailed dive into the potential partner's experience on similar projects and its relationships with the owner and subcontractor market in the project region may require market research, but is a must-do. Finally, contractors should learn each other's risk appetite by discussing desired profit margins, willingness to accept project risks passed down by owners, approach to analyzing the likelihood of project risks materializing and appropriate contingencies, as well as their experiences in prior JV relationships, including management and dispute resolution structures.

C. Critical Terms in the JV Agreement

We found each other – now let's make it official. Joint Venture best practices dictate that the parties negotiate and finalize the terms of their JV relationship prior to submitting their bid (or if the pursuit is a two-step process, prior to submitting their statement of qualifications). The devil is always in the details, especially when relating to a legal agreement, so it is imperative that the JV partnership is clear and solidified to avoid or address disputes post-award. Determining which contractor will be the managing party, the decision-making authority of the managing party and what decisions require unanimous approval are of the utmost priority. Ideally, unanimous consent is required for all decisions; however, a process to timely progress the project must be in place in case of disagreement. Often JV agreements permit the managing party to move forward with its decision if necessary to progress the project and compliance by the minority partner is mandatory, subject to further dispute resolution. The agreement may identify certain types of partner disputes requiring accelerated dispute resolution and may appoint a named neutral party/mediator who will be kept apprised of the project and any issues. This will ensure a knowledgeable decision-maker and prompt resolution of any disputes.

Additionally, the list below highlights other important provisions which should be agreed upon prior to submitting a statement of qualifications or RFP proposal.

- <u>Percent ownership</u>: Each party's percentage interest in the JV (e.g., 60%/40%) and whether the JV will be an integrated JV or a line-item JV. In an integrated JV, the parties share both project profits and losses in accordance with their percentage shares in the JV. Conversely, in a line-item JV, the parties' scopes are clearly segregated and defined in an exhibit to the JV, the parties each retain their own subcontractors and suppliers (although some may be shared), and the profits/losses are realized separately with respect to those individual scopes. Note, however, that whether the JV is integrated or line item, the parties will have joint and several responsibility with respect to claims by the owner or third parties. For example, if one party goes out of business, the remaining party is responsible for full completion of the project, all payment obligations and liability for all claims (subject to indemnity provisions as discussed below and applicable bankruptcy laws).
- <u>Treatment of bid costs</u>: Will the pursuit costs be included in the bid price and reimbursed post-award? Will the partners pay for third-party pursuit costs (e.g., design firm compensation) in accordance with their percentage interest in the JV? How will they handle the loss of a stipend due to a non-responsive bid? How to handle the scenario where one partner drops the pursuit prior to submitting a bid?
- <u>Decision-making</u>: As discussed above, identify all categories of JV decisions that require unanimous approval by the Executive Committee. Often this list includes the following:
    - Amendments to the JV agreement
    - Major increase of the owner contract scope of work
    - The requirement for and amount of a capital contribution by the parties
    - Approval of subcontracts and purchase orders in excess of a certain dollar threshold
    - Settlement of owner or subcontractor claims in excess of a certain dollar threshold
    - Disposition of JV equipment and materials

  - Insurance coverages, limits and deductibles; member corporate policies versus joint venture project-specific policies
  - Return of working capital or payment of head office overhead or profits to the parties prior to termination of the JV
  - Any decision to suspend or terminate the owner contract
  - The amount of any reserves required for the warranty period and/or for unsettled claims
- Management Fee: Will the managing party be entitled to a management fee and if so, how much? Typically, the management fee is either a set dollar value or a percentage of the contract value paid monthly. All corporate administration services that are included in the management fee should be identified in an exhibit, as well as what costs are considered JV costs versus individual party costs.
- Dispute Resolution: What is the process to resolve disputes in the event of disagreement and identification of disputes requiring accelerated resolution?
- Default: Default events, cure periods, and the effect on voting rights during default and termination. Typically, even in the event of default, the original percentage shares in the JV will dictate the responsibility for losses on the project. This is necessary to disincentivize a partner from intentionally defaulting on a bad project in order to minimize its share of the losses.
- Capital Calls: Failure to contribute working capital when required by the managing party, including the option for the non-defaulting party to contribute such capital as a demand loan to the defaulting party and the effect on voting rights, repayment of working capital and profits, and responsibility for losses.
- Indemnification: The JV agreement should contain an indemnification provision whereby in the event one party pays more than its percentage share of a loss or claim, the other party must indemnify its partner for the excess portion paid. Fraud and intentional misconduct are excluded from this indemnification.
- Parent Company Guarantee: Whether the parties will exchange parent company guarantees. This is often desired when a parent company has a stronger balance sheet than the operating entity in the JV.
- Self-performance: The JV agreement should address whether either or both parties intend to self-perform any of the scope of the work or how to handle self-performance if this is determined post-award. Issues to address include whether such work will be subcontracted to the JV party, whether that party will first compete with other bidders for such work, what the allowed profit for such work will be and whether the profit is shared between the JV partners in accordance with their percentage shares or whether the party self-performing the work takes on all profit and loss responsibility.
- Key Personnel: Designation of each party’s key personnel who will commit to remaining on the project through completion. Ideally, the list of key personnel is set forth in an exhibit to the JV.
- Signature Authority: Identification of project personnel levels, up to the Executive Committee, permitted to bind the JV in written agreements, typically categorized by the types of agreements and/or dollar amounts. A requirement for both parties to sign checks/money distributions may also be agreed upon for certain dollar thresholds.

D. Insurance and Bonding

The Joint Venture members have options with respect to meeting the owner's insurance requirements and protecting the JV with additional desired coverages. They can utilize member corporate policies, obtain project-specific joint venture policies, or a combination of both. Often the JV members will utilize corporate policies for the workers' compensation and auto liability policies, especially where the JV has no employees and the project personnel simply remain employees of their respective companies. However, when the JV will have its own employees, and on larger or more complex projects where loss exposures are higher, best practices dictate that insurance policies be obtained specifically for the project in the name of the Joint Venture. In fact, regardless of the size or complexity of a project, many would argue that project specific policies should always be utilized for joint ventures (with the possible exception for workers' compensation and auto liability). Note that project specific policies may be procured for all required or desired coverages – for example, workers' compensation, commercial general liability, auto liability, umbrella/excess liability, contractor's professional liability, contractor's pollution liability, contractor's equipment and builder's risk.

While project specific policies are typically more costly than using corporate policies, there are many significant benefits including, most importantly, protecting the contractor members' corporate insurance from losses which could erode aggregate limits and also result in negative underwriting and higher premiums far into the future. Project losses instead remain isolated to the project and corporate insurance programs are unaffected. Additionally, project specific JV policies avoid ambiguities about who is insured, whose policy responds, who caused the loss, and eliminate subrogation issues and coverage disputes among the various members' insurers. Another benefit is that project specific JV policies may provide broader coverage options tailored to the project, eliminate potential gaps in coverage that may arise when using corporate policies, and align coverages and limits with the project's true risk profile. Finally, project specific policies enable faster claims handling and resolution since only one carrier (or coordinated market) is involved and carrier finger-pointing which may occur when multiple corporate policies are used is eliminated.

As discussed previously, one of the reasons a contractor may choose to joint venture, especially on a large project, is due to bonding capacity restraints and/or its surety may be conditioning surety support on the contractor teaming with a strong joint venture partner. Contractors and their sureties know the benefits of sharing capacity, personnel, resources and risk. When a contract is awarded to a joint venture team, the required performance and payment bonds are issued to the owner/obligee in the name of the joint venture as the principal. Although not always the case, usually each JV member is responsible for its percentage share of the bonds in accordance with its percentage share in the joint venture, and each member's surety(ies) become co-sureties for the project. Just as the joint venture members are jointly and severally liable to the owner under the contract, absent written agreement otherwise, each joint venture member is jointly and severally liable to each of the co-sureties for full performance of the bond obligations regardless of their JV percentage shares. Similarly, each of the co-sureties are jointly and severally liable to the owner/obligee on the bonds. However, the co-sureties will enter into their own cosurety agreement typically apportioning liability in accordance with their contractor's percentage share and addressing indemnity obligations among them in the event of a loss.

E. Licensing and Registration

Depending on the jurisdiction of the project, even where both partners are licensed, the JV itself may need to obtain a license – in some jurisdictions prior to bid and in others prior to execution of the construction contract. The requirements can include a contractor's license, formal registration of the JV as a legal entity (e.g., partnership or LLC), fictitious name registration ("doing business as"), municipal business license, and/or tax registration, among other things. Prior to bidding a project, the JV should know what the licensing and registration requirements are in the project jurisdiction.

F. The Dedicated Subcontractor Option

If parties determine that joint venturing is not desired, they may still decide to team on a bid in order to take advantage of their joint qualifications and experience. Often proposals must include a list of key subcontractors. The general contractor and the key subcontractor can enter into a "dedicated subcontractor" teaming agreement whereby they agree to bid and/or complete the project exclusively with each other and they may have the ability to include the teaming agreement in their proposal which may boost their scoring in the bid evaluation process.

G. 'Til Dissolution Do Us Part

Like all successful partnerships, a joint venture requires the parties to be reasonable, nimble, and committed to the relationship until completion of the project. Further, the JV partners should be like-minded on important issues, priorities, values and culture. The importance of conducting due diligence on potential partners, ruling out any potential conflicts of interest, and ensuring the right fit before the project pursuit is underway, cannot be emphasized enough. Once awarded a project, the joint venture partners will need to work hard to maintain an agreeable and trusting relationship, dedicated to the success of each other and of course, ultimately, the project.