ReedSmith

Working with a joint venture or consortium contractor: getting the best out of the relationship

Author: Vincent Rowan, Partner, London
Author: Joseph Otoo, Associate, London

Publication Date: December 13, 2011

Introduction

Joint ventures and consortiums have become increasingly important as a medium through which international contractors can undertake significant projects. As producers, traders and owners seek to expand their infrastructure assets, there has been an increased need to consider engaging or partnering with a joint venture or consortium contractor in order to tap into a particular expertise, or work with companies active within a particular geographical location. This client alert looks at some of the factors to be considered and the risks to be aware of when working with a joint venture contractor or consortium (JVC).

Why consider engaging a JVC?

Where the project and investment is significant, a JVC relationship tends to be the most widely used vehicle through which contractors can establish a presence in a specific jurisdiction for the purposes of undertaking projects or managing business opportunities.

There are a number of commercial benefits to engaging a JVC:

— **Capital intensive:** the construction of large energy and infrastructure projects can be too big for a single company to undertake on its own. A JVC allows contractors to pool their capital and assets in order to undertake capital intensive and technically challenging projects without stretching their balance sheet.

— **Risk concentration:** the risk profile attached to large projects tends to be such that no single company is prepared to take full exposure.

— **Access to technical expertise:** the contractors in a JVC may be leaders in a particular proprietary technology or possess particular expertise which would not ordinarily be found within a single company. Collaboration between complementary skill sets presents a powerful proposition for any owner when considering who to work with on a project.

— **Supply chain efficiencies:** the efficiencies of supply chains across long distances may increase by the pooling of assets, know how and networks between the JVC participants.

— **Regulatory requirements:** some countries require foreign contractors to partner with local entities if they are to enter into that market. Where local contractors are unable to undertake a project on their own, they are likely to partner with an international contractor with the expertise they do not possess.

Choosing the right JVC

A significant contributor to the success or failure of engaging a JVC on a project is not only its relationship to the owner, but the relationship between the participants within the JVC. Therefore, choosing the right JVC to engage is not only about expertise, size and location of the participants, but also financial strength, legal structure, internal management and control, and corporate culture.

Financial strength

Whilst an initial due diligence of the JVC may reveal a strong financial position, it is necessary to test this against a future position. The risk here is that the aggregation of commitments on a large long term project, or across a portfolio of smaller projects, could stretch their financial resources, thereby hindering their ability to meet their obligations.

Internal management and control

One of the key areas of risk with engaging a JVC is the nature of the relationship between its participants and the level of control each of them wield. The JVC must have strong internal processes and a verifiable track record regarding its ability to deliver projects. A JVC made up of participants with strong corporate governance and a proven track record will have a greater ability to deliver projects on time and within budget. Furthermore, participants with a good reputation may be more concerned with the risk of adverse reputational damage consequent upon a failure to perform.

Prior to engaging a JVC, it is therefore necessary to understand the nature of the agreement between the individual participants. In this regard, it is advisable to request a copy of all JVC and/or co-operating agreements between the participants at the tender stage of the project. Where there are areas which may present risks to an owner, these can be addressed. For example, there may be risks involved where a JVC will be sub-contracting some of its work or engaging key suppliers. In this case, owners should consider whether they want to place certain restrictions upon the ability of the JVC to award contracts to third parties for the performance of the works (e.g. the need for prior owner consent). The aim here is to provide some oversight into the award of contracts and ensure such contracts are let on a transparent basis to the best qualified and most cost effective third party. In circumstances where there are many third party contracts to be awarded and where approval of each award is impractical, provision may be made for owner approval to be required only where the price of the contract award is over a defined value or related to a key element of the project.

Legal structure

The manner in which a JVC operates and is managed depends to a large extent on its legal structure and the depth of integration between participants. Whilst shallow integration may cover a marketing alliance or a joint operating agreement, the in-depth integration approach may (but is less likely to) involve participants transferring businesses and assets to a newly formed project company in exchange for shareholdings, or transferring assets to an existing company in exchange for shares.

Owners should ensure they are provided with sufficient information in order to understand the nature of the agreement between the participants in the JVC. Normally, vis-à-vis the owner, the participants in the JVC will be jointly and severally liable for the performance of the construction contract. The practical effect of this is that an owner may proceed against any one or more of the participants in the JVC for full performance of the project contract (or alternatively, for all its loss or damage arising from a breach or failure by any one of them to perform), irrespective of which of them caused the breach.

A corollary of this is that full performance by one of the participants discharges the liability of the others as against the owner. In such a situation, the participants will normally have rights of recovery against each other.

Sale, transfer or changes within the JVC

The profile of the participants in a JVC may be varied, and can often be made up of industry or technical specialists, suppliers, funders and even government entities. It is not always the case that the departure of one participant spells the end of the collaboration. Where a sale, transfer of interest or other change takes place, the joint venture or co-operating agreements must ensure this can be done smoothly, with minimal disruption to the project. For example, confidentiality agreements vis-à-vis the owner and the JVC or as between the participants themselves must on the one hand protect the commercially sensitive information of the owner, whilst on the other hand facilitate the disclosure of information a would-be entrant would require in order to perform commercial and legal due diligence on the JVC. In circumstances where a sale or transfer may take place between participants, provisions may exist which give the owner the right to question or to block any sale or transfer. However, it is imperative that owners exercise care when using such rights and avoid stifling the internal decision making of the JVC (which may be motivated by genuine commercial or technical factors) or otherwise contribute to destabilising the JVC's ability to fulfil its obligations.

Bait and switch

Where such controls may be useful is in 'bait and switch' situations. In such situations, leading international contractors may collaborate with smaller and less well known companies to bid for a project. The mix of expertise, reputation and experience may induce an owner into choosing this JVC over others. Once the contract is awarded, the leading contractor will take a minimal role while the less well known contractor will take the lead. The bait is the world renowned international contractor leading the project. The switch is the less well known contractor taking the lead once the contract has been awarded.

The main reason for this can be profit. Whilst an owner may be prepared to pay a premium for the involvement of leading expertise, such a premium may not be paid where the contractor is less well known. Once the premium price contract has been awarded, the leading contractor will take a percentage of the premium price and a less prominent role, while the less well known contractor executes the majority of the works for a cheaper price.

In such situations, an owner should have full disclosure of any internal changes of the JVC. Such disclosure should be accompanied by the power to block changes which resemble a 'bait and switch' situation and/or to review the continuation of the contract.

Performance and payment

Working with a JVC contractor comprising a number of participant companies should not affect the owner's important rights and obligations concerning payment and performance security typically found in the construction agreement.

Owners should resist requests for multiple bonds and guarantees being provided by the individual participants in the JVC, especially when the same are to be provided by different banks, on different terms from different (home) jurisdictions.

Owners should require just one bond or guarantee to the required full value from a recognised bank on terms and from a jurisdiction which respects the nature of the security provided by such instruments.

On the same basis, owners should resist requests for separate payments to be made to the JVC participants in respect of the works and services provided. All payments under the construction agreement should be made to one named and nominated bank account of the JVC.

It is the JVC itself that should administer how bonds and guarantees are to be procured on behalf of the participants and the mechanics of how any counter security is given to the issuing banks and in what proportions. The JVC should also be responsible for administering the receipt and disbursement of payments made by the owner to the JVC under the terms of the construction agreement.

Conclusion

JVC's undertaking large construction projects are becoming common place in international contracting. Such commercial relationships are a useful way of gaining the benefits of collaboration between a range of experience and expertise whilst avoiding the risk concentration of reliance on a single company.

However, owners need to be aware of how they might need to adjust the manner in which they approach the project management of a contract in order to address some of the risks associated with working with a JVC. The key to success is:

- Working with a JVC comprising companies who represent a true blend of necessary expertise and who have a common goal of excellence in project delivery, perhaps based on a long track record of working together.
- Ensuring the owner is aware of the legal structure and obligations that exist between the JVC participant companies, including their respective work scopes and how the JVC will manage the project and any risks that arise.
- Ensuring the JVC participant companies are jointly and severally liable for the performance of the construction contract.
- Ensuring a level of transparency and control in relation to any proposed changes to the make up of, and participants in, or commitment to the JVC.
- Ensuring, notwithstanding the use of a JVC, clear lines of communication with the JVC for the management of the project, the payment of monies to the JVC for the works undertaken and the provision of the performance security covering the JVC's obligations to deliver the project in accordance with the construction contract.