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Tools For Energy And Infrastructure Minority Partners: Part 2

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The joint-venture investment is an increasingly popular structure for energy and infrastructure plays and projects. While it is often the case that the majority party in a joint venture has controlling rights over how the business operates, minority parties are coming up with creative ways to exert influence and control beyond the level typically associated with a minority party's ownership interest level.

This two-part article highlights some of the ways that we have seen this trend present itself, along with some considerations and drafting notes gleaned from our experience working with, and against, minority parties in joint ventures.

The first installment discussed the importance of identifying your and your counterparty's key objectives, the value of entering the joint venture at the beginning and the advantages of serving as the operator of the project. This installment will focus on establishing minimum exit thresholds, vetting capital contribution terms and knowing how to pick your battles.

Set Minimum Exit Thresholds

The transfer provisions of an LLC agreement or assignment provisions of a joint development agreement are often some of the most heavily negotiated and contested sections of those agreements.

In most of the joint-venture agreements we have worked with, a majority party is afforded a right of first offer and a tag-along right should the minority party wish to sell its interest in the joint venture, as well as a drag-along right should the majority party wish to sell its interest in the joint venture. The tag-along right allows for the majority party to include its interest in a sale entered into by the minority party, and the drag-along right allows for the majority party to force the minority party to include its interest along with the majority party's interest in any sale transaction that the majority party enters into.

Most minority parties would like to have these rights as well, but are not likely to get all of them. Many minority parties focus on the majority party's drag-along right, and fight hard to prevent that right from being included in the joint-venture documentation. But majority parties also fight hard for the drag-along right, because they often believe that having the ability to deliver 100% of the equity interests of the joint venture (or all of the assets) enhances the marketability of their interest, allowing them to offer a prospective purchaser a choice between purchasing a controlling stake in the joint venture or all of it.

Successfully negotiating these provisions can be difficult, given the competing needs of the majority partner and the minority partner, and usually the minority party is forced to relent because excluding the majority party's drag-along right is not in line with market terms. (The validity and efficacy of the market

terms argument is not the subject of this article, but suffice it to say that each deal is different and should be approached with that in mind.)

In consideration for allowing the majority party to have a drag-along right, a minority party may put limitations around when, and for what economic return, the majority party may invoke its drag-along right. This allows the minority party certain levels of surety about how long they will be involved in the joint venture, and what the takeout economics might look like if they are forced to sell out of the joint venture before they are prepared to do so voluntarily.

For example, an international minority party might make the argument that marketing its participation in a U.S. renewable energy joint venture is important to it, so that people know how green they are and that they are a player in the U.S. renewables market, and was part of the value proposition for entering in to the joint venture in the first place. If they were to be dragged along in a sale three months after buying into the joint venture, that marketing value would go away; therefore, they should be entitled to a takeout premium for agreeing to the drag-along right.

These types of time limitations and sale transaction economic metrics can also be applied to a sale of all or substantially all of the assets of the joint venture, but this carveout would most likely appear in the list of supermajority decisions as opposed to the transfer provisions — being listed as something that the company may only do with supermajority consent if the sale is prior to the agreed period of time, or on economic terms less favorable than an agreed benchmark.

A savvy minority party will push to have this covered in both the transfer provisions, with respect to an equity transfer, and in the supermajority decisions, with respect to a sale of all the joint venture's assets.

Thoroughly Vet the Capital Contribution Mechanics

Capital contribution mechanics tend to vary quite a bit, depending on the purpose of the joint venture and the parties involved. In some instances, no party is ever required to make a capital contribution beyond its initial one, and any additional money raised by the company must be through debt or new equity issuances. This might be applicable in a toll road project, where there is not a high volume of capital expenditures from the joint venture after a certain point.

In other situations, there are agreed post-effective date capital contributions which all partners are committed to make under specified circumstances. This might be applicable in an upstream oil and gas operation, where the joint venture will seek to acquire certain amounts of acreage immediately after the joint venture is formed, or where future development drilling costs are to be funded with equity capital contributions from the existing partners.

In any case, these mechanics and requirements tend to be highly specific to the business or project, and should be thoroughly considered by a minority party, and discussed between the parties, prior to agreeing to the applicable capital contribution regime.

A common mechanic that we have seen is that a party may be diluted if they do not make a capital contribution, but may also increase its ownership interest if they elect to fund the excess capital outstanding for a party that does not participate in a capital contribution. These provisions can be problematic for a minority party, because they may lead to unexpected future requirements to contribute

capital into the joint venture or face dilution, thus becoming more of a minority owner in the joint venture than they already are.

But again, this is an area where an astute minority party may protect itself, by putting limitations on the number and amount of capital contributions that the company may request each year, by extending the time period for providing notice of a requested or mandatory capital contribution, and by limiting required capital contributions to qualified investments that meet certain specified metrics or business objectives.

The qualified investments limitation can also migrate into the supermajority decisions list, such that the company may only pursue investments outside of qualified investments with supermajority consent (including approval by the minority partner's representative on the joint-venture board).

For example, in a terminal project, constructing additional storage capacity might be a qualified investment, as that would be in line with the purpose of the joint venture and potentially increase revenues. But the purchase of multiple corporate jets for use by the executive officers should probably not be a qualified investment, and therefore, the funding of that purchase should not be subject to a required capital contribution and/or should require supermajority consent.

In the scenario mentioned above, where no member is required to make any additional capital contributions, and the joint venture will only raise additional capital through incurring debt or issuing new equity, there are important concepts for a minority party to keep in mind to prevent future dilution. Creating a limitation on the amount of debt that may be incurred without the minority party's consent is important, and can be included in the supermajority decisions. Another important concept to include is preemptive rights for all members, so that any issuance of new equity is subject to the right of all members to participate in that issuance to maintain their current ownership interest level.

Here again is an area where a limitation on new equity for qualified investments should be considered, but also a limitation on parties to whom the joint venture may issue new equity. If the joint venture may freely issue new equity, subject only to a member's preemptive rights, this echoes the capital contribution dilution discussion above, where a minority party may find itself forced to either fund unexpected amounts of new equity in the joint venture to maintain its ownership interest, or face the resulting dilution.

Arguing for a requirement that new equity must be issued to a true third party in that scenario, or seeking to institute similar volume and timing limitations as those discussed above around the new equity, may assist in limiting a minority party's dilution risk with a majority party seeking to push the minority party out or limit its control.

Pick and Choose Your Battles, and Keep a Good Poker Face

Returning to the all-important theme of knowing what you want to get out of a joint venture, it is important to strategically narrow down the points that matter most during the course of negotiations, so that the final joint-venture documents will include the provisions that are most important for projecting the minority party's particular objectives. But to get all (or at least as many as possible) of its key objectives, a minority party needs to be careful not to tip off the majority party too early as to what those points are.

The minority party should also identify the most important points for the majority party, and continue to make advances on those points, so that the majority party does not feel as if inclusion of those key rights is a fait accompli. By making itself aware of the different tools at its disposal, being creative and

constructive about how the minority party might add value to and extract value from the joint venture, and remembering (and reminding the majority party) that every deal is different, a minority party might successfully negotiate its way into a joint-venture arrangement that gives it the desired protections — and perhaps as a result the desired overall outcome — that it envisioned when first considering the joint-venture investment.

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