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Joint Ventures: Costly If Not Cautious

By Adam Canosa and Robert Mercado | Tuesday, April 2, 2019

The construction industry continues to witness the creation of joint ventures among contractors of all sizes, and for a variety of reasons. Companies may wish to share the risk on a project, secure additional bonding capacity or enter a new market segment with a more experienced contractor, as well as offer additional resources, including working capital and other trades needed for a project. However, many risks need to be addressed prior to officially forming a joint venture.

Joint ventures involve the union of two or more entities in the interest of completing projects as one entity. The partners create an operating agreement that outlines the joint venture structure and includes, but is not limited to, roles and responsibilities, rates and overhead cost, funding of losses, and early cash distributions and closeout. If not outlined carefully, any one of these items could detract from the joint venture's success.

Entity Structure

Joint ventures typically are set up as a partnership, LLC or corporation. Choosing how to set up the joint venture is contingent upon how the contractors want to report it on their individual financial statements. Contractors should work with their accountants and attorneys to structure the entity accordingly, in an effort to address legal and financial reporting concerns before a project begins. This is important because there could be significant financial reporting requirements depending on how the joint venture is structured at the time of its inception.

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Roles and Responsibilities

Unclear assignment of responsibilities and the governance of the joint venture could cause costly dissention among the entity partners. It is imperative for the operating agreement to clearly indicate the exact responsibilities of important roles, including:

- the sponsor or operating party (managing partner);
- the accounting party (financial records); and
- project-specific assignments.

Rates and Overhead Cost

Rates related to the cost of equipment, labor and burden for hourly employees, overhead rates, insurance, etc. will vary among contractors. Partners will charge these rates to the joint venture, so they need to be specified in the operating agreement. Rates can be based on actual costs or an agreed upon rate for each item.

If actual cost incurred is used, the joint venture partner normally will provide third-party invoices for purchases. Internally prepared reports for items such as equipment cost or labor should be generated.

Actual cost can be more difficult to manage and support than a fixed rate. In addition, compensation to the managing partner as well as the cost of handling the accounting and other matters by one of the joint venture partners must be considered. This rate may be based on a percentage of the revenue, a percentage of the cost incurred or a flat rate.

Funding of Losses

Unforeseen conditions can create a loss for the joint venture. If this happens, the partners will need to fund the joint venture in the absence of profit. It is imperative that all parties know the funding capabilities should a loss occur. The financial stability of the joint venture partners should be disclosed before contractors merge. If a partner doesn’t have the ability to fund a loss, the other partner(s) will have to step in to fund those losses.

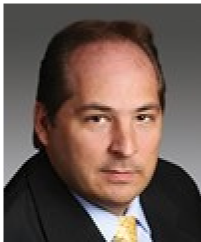
Early Distributions and Closeout

Cash from the profits of the joint venture could accumulate as the project progresses. A schedule of cash distributions to the partners should be determined and outlined in the agreement to avoid any confusion or conflict. If a partner requests a distribution based on cash available, this could impact the cash needed to support the future cost of the joint venture.

Most joint ventures will not permit cash distributions of profits until the project is greater than 50 percent complete. This safeguard allows the joint venture to reserve the cash flow needed to perform and complete the project. This distribution rule affords the joint venture a clearer understanding of profitability as the project nears completion, as compared to early stages.

If the joint venture is set up for one specific project, then the entity is terminated upon completion. This process of termination should be discussed, agreed upon and included in the operating agreement. Issues to outline in the operating agreement regarding the closeout phase should include what the warrant period will be for the project and when final partner distributions will occur.

Before entering into an agreement, it is imperative to seek accounting and legal advice from qualified counsel with expertise in construction joint ventures. A strong and steadfast agreement provides clear guidelines, eliminates confusion and minimizes costly misinterpretations prior to, during and upon completion of the project.



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