What You Need To Know About Joint Ventures in the Construction Industry:

Part 1
The benefits and risks and how to choose a partner

Part 2
The Joint Venture agreement

Part 3
Joint Ventures involving the federal government's small business programs and the potential liability sureties may face

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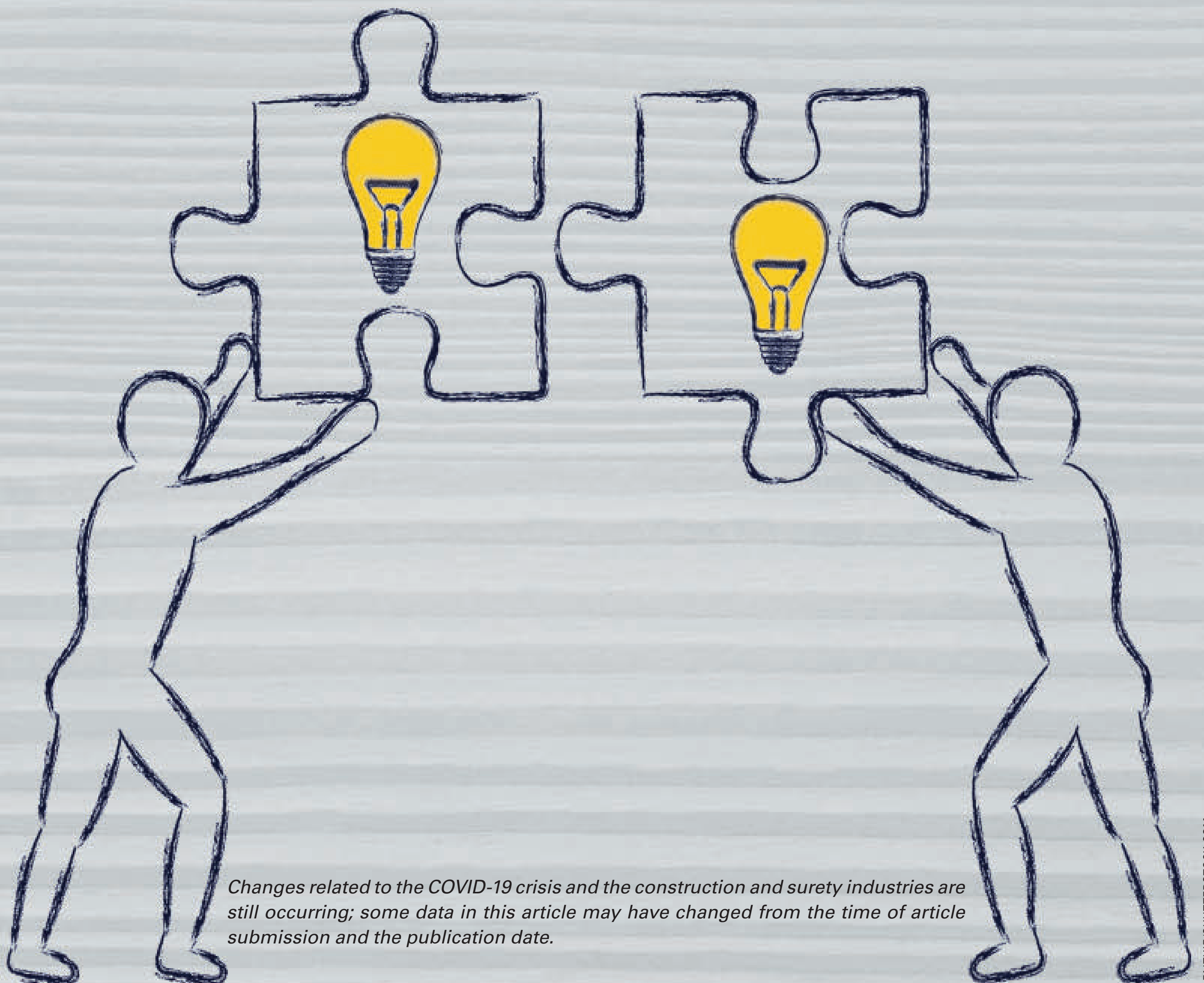
feature

What You Need To Know About Joint Ventures in the Construction Industry:

Part I
Benefits, Risks, and Considerations



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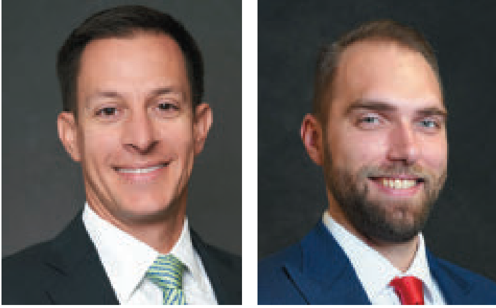

Joint ventures balance risk, reward, expertise, and resources, but caution is advised.

BY MICHAEL C. ZISA AND JOSHUA A. MOREHOUSE

A JOINT VENTURE (JV) is a partnership between one or more businesses to take on a commercial enterprise. JVs have been used in the construction industry for years but have become increasingly common as projects continue to become larger, more complicated, and more specialized. JVs allow companies to share risks, resources, knowledge, and expertise and increase bonding capacity and market reach. While the opportunities presented by JVs are enticing, contractors (and bond producers and sureties providing bonds to a JV) must understand and carefully consider a number of factors before taking the leap into the world of JVs.

The following is the first of a two-part article on the use of JVs in the construction industry. This part covers the factors that weigh on a contractor's decision to enter into a JV, including the benefits and risks of a JV and how to choose a JV partner. Part II will cover the essential elements of a JV and how the parties can protect themselves when drafting a JV agreement.

Why Choose A Joint Venture?

There are many reasons why contractors pursue projects as a JV instead of independently. The first reason is risk sharing. Construction projects are inherently risky, and those risks increase as the size and complexity of projects increase. Some of the largest—and potentially most profitable—construction contracts also carry the highest risk. In order to capitalize on these opportunities, contractors often desire to share this risk.

The risk inherent in large construction projects has become even more pronounced as the popularity of alternative project delivery methods has increased. When handling a design-build or engineer-procure-construct project, a contractor assumes liability not just for building the project, but also for designing or engineering it as well. Many articles have addressed the potential efficiencies that can come from such an arrangement, but the contractor's risk increases, too. A JV allows multiple parties to control and share that risk.

Another reason to use a JV is to take advantage of the differing expertise between partners. For example, one partner may specialize in open-cut excavation, and the other partner in micro-tunneling. Or, in a design-build project, one partner may be an expert in design while the other excels in construction. While neither specialty on its own may be able to fully perform a construction project that requires both tasks, combining the specialties in a JV allows the partners to competitively bid and perform the entire project. While contractors could use the traditional contractor-subcontractor relationship, such relationships can be adversarial and result in disputes. This is especially true in large, high-risk projects. The JV relationship, on the other hand, gives both partners a direct interest in the project's success. Hence, partners often experience a greater desire to cooperate for the good of the project, ultimately producing a more profitable job.

The JV structure also allows partners to pool tangible and intangible resources. One partner may have the necessary financial strength to perform a long-term or high-risk project but lack other expertise, knowledge, or resources necessary to perform the project. For instance, a large construction company may have the experience and resources to perform a project. Yet the project may be located outside of the geographical market that the contractor typically works in. A smaller contractor may have knowledge and experience regarding the local market but not the experience, resources, or bonding capacity to compete for the project on its own. A joint venture allows each partner to benefit from the other's strengths.

A contractor can also enter into a JV to increase its available bonding capacity. Most public projects require a contractor to post payment and performance bonds. Many private projects do the same. By teaming up with another contractor, a party that otherwise lacks the capacity to obtain a bond can, with its JV partner, post a bond. This advantage is most pronounced for small contractors, for which posting a large bond may be simply impossible. For those contractors, increased bonding capacity may provide access to otherwise unobtainable projects. But even larger contractors may be unwilling to tie up a significant portion of their available capacity on a single project. Using a JV allows the partners to increase available bonding capacity by sharing that capacity in the JV.

Finally, working through a JV may provide access to otherwise unobtainable small-business or other

continued on page 22

set-aside programs. While state and local requirements vary, one example at the federal level is the Small Business Administration's 8(a) mentor-protégé program. That program permits a large business to form a JV with a small business that—under certain circumstances—can be eligible for projects set aside for small businesses. Without a JV, these projects would be otherwise unavailable to the larger contractor or the smaller contractor alone.

What Risks Are Associated With a Joint Venture?

Of course, although forming a JV can provide a variety of benefits, it can also have its drawbacks. First and foremost, the JV partners' liability—both to third parties and to each other—cannot be overlooked. One key aspect of a partnership is that each partner is jointly and severally liable for the actions of the JV and its partners. In other words, each partner is liable for its other partner's actions; even sophisticated contractors do not always grasp this concept. Therefore, if one partner fails and is no longer able to perform, the other partner remains obligated to fulfill all of the JV's obligations.

The second form of liability in a JV is the liability between the partners, which is normally governed by the terms of the agreement. Most often, the managing partner will limit its liability to gross negligence or bad faith. Generally speaking, this is an agreeable position, as managing partners should not have unlimited liability for all errors in judgment to their JV partners. The business judgment rule (which holds that a court will not second guess the decisions of an executive as long as the decisions were made in good faith, with reasonable care, and with the reasonable belief that the executive is acting in the best interests of the corporation) usually will protect managing partners.

Even when its liability is limited through the JV agreement, a contractor considering a JV should be aware of the risk of disagreements among JV partners. The JV agreement will typically provide for dispute resolution procedures among the parties. Yet even where these procedures are defined and implemented perfectly, resolution of disputes brings costs both in the financial and efficiency realms. Few contractors (and fewer owners) wish to see a project delayed while a JV resolves its own internal struggles.

Due to the nature of a JV, each party must be willing to cede some level of control to the other. The parties typically allocate the decision-making authority and processes through their JV agreement. Nonetheless, both parties must recognize that they will surrender some autonomy when entering into a JV. Even if one party holds most of the decision-making authority under the parties' JV agreement, that party will likely have to consider the other party's welfare before making significant business decisions. This lack of independence may rankle contractors used to working alone.

On a similar note, entering into a JV may carry reputational risks to a contractor. Joining with another entity in a JV to take on a construction project stamps a contractor's name on that project—often literally. Should that project fall through, or should the other party fail to appropriately perform its obligations on the project, both parties face a risk of reputational harm. To that end, it is imperative that a contractor considering a JV trust its co-venturer to properly perform its work.

In additional to reputational harm, a JV member opens itself to monetary liability should its partner fail to properly perform the project. The most obvious risk of liability lies in one member's deficient work on its portion of the JV. Even though the other member may perform its work properly, it risks having to pay for its portion of the other party's liability charged to the JV. But there are other issues of liability inherent in a JV that may be less apparent. Other government regulations, such as OSHA requirements, can result in contractors facing fines or penalties for work that the JV performed. In extreme cases, a JV member can even risk debarment. FAR 9.406-5(b) permits the United States to impute the fraudulent, criminal, or other seriously improper conduct of one JV party to other participating contractors.

JV members should also be aware that they may face capital calls under the JV agreement. While typically unnecessary as long as the JV turns a profit, unexpected events can often affect a JV's profitability in both the long- and short-term. The JV agreement will typically provide a procedure regarding which party or parties must make contributions to cover a shortfall, and any party to a JV must be ready to meet any such obligations. In addition, a JV member should be aware of the other members' obligations and should be prepared to take proper steps if those members fail to meet them.

What Should a Contractor Consider in Choosing a JV Partner?

For all intents and purposes, a JV is a marriage. As we all know, it is wise to get to know your partner before jumping into a marriage. The same is true for partners to a JV. Of course, prospective partners must evaluate financial stability and competence to perform a particular project before entering into a JV; but there is more to consider. Those considering a JV must take the necessary time and ask the right (and sometimes tough) questions to understand other important aspects of a prospective partner's business, including culture, management style, risk tolerance, business processes, and goals.

Are the partners' business cultures compatible? The concept of a company's culture encompasses a host of values and beliefs that affect how the employees of a company view and interact both internally and externally. JV partners will be working closely, and inevitably there will be tension, so taking the time to ensure that the partners' cultures are complementary is critical. Similarly, the JV will be interacting with the outside world, the owner, and the surrounding

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community; so it is important that the partners carry themselves in a consistent manner.

What are the partners' management styles? Are decisions made collaboratively or independently? For example, if both companies value interdependence, they will expect to collaborate and make decisions together. If, however, there is a disconnect—if one values interdependence while the other values independence—tension can easily result. Employees from an interdependent culture may consider another employee's independent actions selfish, poorly thought out, or attempts to avoid the group input that they typically expect. Employees from an independent culture, meanwhile, might view norms such as regular meetings and collective decision-making as overbearing and stifling. Before entering a JV, companies should, therefore, be conscious of how the management styles will work together and be sure that employees understand how the management will be handled.

What are the potential partners' appetites for risk? On a construction project, a host of decisions are made by considering the relative costs, benefits, and risks of multiple potential paths. Different firms may—and likely will—have different opinions on what level of risk is acceptable. Some firms may be willing to accept additional risk in order to minimize costs and profit. Others may be happy with a smaller but relatively predictable profit in order to avoid risk. Again, companies considering a JV should be aware of their own ideal risk profile along with those of their potential partners.

How do partners view the timing of distribution of profits generated from the project? Some contractors have the policy and financial means to retain profits in the JV until completion of the project in the event unexpected issues arise. For some contractors, however, withholding profit until completion of the project is not an option. It is essential that the prospective partners address this issue upfront.

Are the potential partners' business processes and use of technology compatible? Internal processes for costs tracking, project management, and communication may differ between companies. This is especially true when companies rely heavily on

technology. If the parties use different processes or platforms to manage these kinds of activities, they must ensure that the processes are discussed; and everyone must be given the proper training.

Companies may also differ regarding the benefits and expectations for employees. JV partners may have different policies regarding sick leave, vacation, or hourly requirements. This holds especially true when the partners are used to operating in different geographical areas, where local regulations and union policies may dictate their procedures. Alone, such differences between the parties' internal business processes do not justify avoiding a JV altogether; but the parties should collaborate to harmonize their processes in order to operate the JV as smoothly as possible.

The JV members' business goals should similarly align, and each member should understand what the others hope to get out of the JV. Although such goals can be as simple as "profit," the concept of profit can vary from member to member. One member may require a JV to prove profitable within a short term (perhaps a year), while another may be willing to sacrifice short-term profits for longer-term rewards. Or a member may be willing to forego profits in order to build a relationship with a particular owner or a particular community.

Differing goals such as these can cause disconnects between the parties not only in the means and methods that the JV employs, but also in the way the JV interacts with the owner. A JV member hoping to preserve a relationship may be eager to settle certain owner claims, while a member primarily interested in profit may desire a more adversarial position. Such disconnects can create significant tension within the JV. It is, therefore, optimal that all JV members should have similar business goals.

Conclusion

JVs can provide substantial benefits to contractors. They permit contractors to compete for projects that may otherwise present unacceptable levels of risk. They open markets that would otherwise be unavailable due to capital or geographic restrictions. And they allow a pooling of tangible and intangible resources that permit a JV to far outstrip the technical capability of any individual contractor.

These advantages, though, can carry drawbacks. By their very nature, JVs require cooperation and trust among JV partners. If this trust is misplaced, a contractor can experience significant losses caused by the inexperience, inattention, or incompetence of its co-venturers. Even where all members of a JV are willing and able to properly perform their tasks, differences in companies' cultures and business goals can create tension within the JV. Such tension carries costs, both from inefficiency and from the dispute resolution process. It is, accordingly, vital that a contractor considering a JV carefully choose its partner before undertaking such a project. The front-end work to confirm that potential JV members will work well together can avoid back-end expenses flowing from disconnects in the members' goals and expectations.

Of course, not even the most careful selection of JV members can completely eliminate the risk of disputes. The next part of this article will address how best to structure the JV agreement to further minimize the risk of disputes and to deal with disputes as they arise. ●

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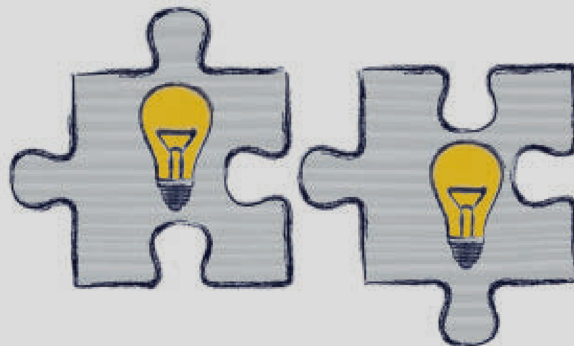

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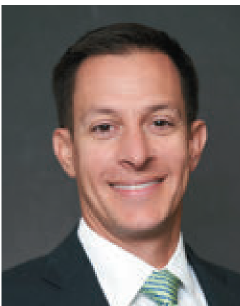
What You Need To Know About Joint Ventures in the Construction Industry: The JV Agreement

Part 2 of 3



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I. Introduction

As described in Part I of this article, joint ventures, or JVs, can offer significant benefits to contractors. In order to realize these benefits, though, the potential members of a JV must ensure that the parties' rights and duties are properly allocated. This allocation will vary with each JV, depending on the members, their resources, and their goals. There is, therefore, no one-size-fits-all approach to drafting a JV agreement. Instead, the parties must tailor their agreement to their particular circumstances, along with the particular project that they are undertaking. This article outlines the major provisions that should be included in most JV agreements, along with how those provisions may be adjusted to meet certain needs.

II. Roles of Joint Venture Members

The members in a JV can play a number of different roles, depending on the goal of the JV. Those roles may overlap, or they may be entirely separate. For instance, the JV members may operate together to provide the same services (for example, general contracting services). Or they can separate member roles by line-item, with each JV member assuming responsibility for specific items of work for a price and receiving the profits or losses it attains on its portion of the work. Although less common in today's market, "silent" JVs have also been used to allow one member to finance the operation while the other performs the work.

The roles that the JV members play will typically determine many contractual provisions. Importantly, these roles often affect how the parties decide to share the profits of the JV. When the members perform similar roles or when one member's role is purely financial, the parties will often divide the profits based upon their agreed-upon percentage interests. In a line-item JV, on the other hand, the members will often be paid purely based upon their own work.

III. Joint Venture Forms

The potential members of a JV must choose the corporate form that the JV will take. This corporate form can have significant consequences for the JV—and thus for the parties. In addition, owners or developers may prescribe or restrict the corporate forms with which they are willing to contract. Potential JV members most commonly choose the corporate forms of partnerships, limited liability companies (LLCs), or corporations. Each form has advantages and disadvantages depending on the type of the project and perspectives of the partners.

Many construction companies elect to use partnerships, which do not create new or separate legal entities. Because no separate legal entity exists, the partners remain jointly and severally liable for the partnership's debts. For that reason, many owners—especially public owners—prefer this arrangement. Conversely, owners may hesitate to enter into a contract with a separate entity, fearing the entity may be undercapitalized and unable to pay any liability incurred to the owner. Indeed, several states' procurement agencies will not accept LLCs as responsible bidders on public contracts.

Yet contractors still often choose to use separate JV business entities, such as LLCs or corporations. When permitted by the owner, such arrangements provide real advantages to the JV members. The most notable advantage, as mentioned above, is the liability-limiting nature of an LLC or corporation. In such arrangements, the liability of the individual contractors is limited to the assets of the separate entity. However, on projects where payment and performance bonds are required, the surety will likely require the members of the LLC or shareholders of the corporation to execute indemnity agreements or corporate guarantees as a condition of providing the bonds. The JV members will, therefore, not be insulated from claims by owners, subcontractors, or suppliers. They may still be protected, however, from claims of third parties.

Potential JV members may also work together to prepare and submit a bid on a project, with an agreement that (if the project is awarded) they will form a JV. Articles have been written exclusively on these "pre-bid" JV or teaming agreements, and a thorough examination of the subject is outside the scope of this article. The parties must be cautious in drafting these agreements: the results can be disastrous if the members cannot agree to the terms of the JV agreement after winning the bid. The parties should thus ensure that they have sufficiently negotiated and agreed to the terms of the follow-on JV agreement. In fact, the parties often make the follow-on JV agreement an exhibit to the teaming agreement.

IV. The Joint Venture Agreement

Regardless of the type or form of JV selected, a carefully drafted agreement governing the relationship of the members is essential for the success of the JV. Several industry organizations—notably the American Institute of Architects and ConsensusDocs®—have issued excellent standard form JV agreements. While these forms provide a good starting point for a potential JV, every JV's needs are unique. Parties interested in entering into a JV should, therefore, carefully consider the terms of the agreement to ensure they reflect the parties' intent and account for unique circumstances. These terms can be loosely grouped into five major categories based upon their functions: general provisions, capitalization, operation, disputes, and termination.

a. General Provisions

i. Name

The agreement must state the name under which the business and affairs of the JV will be conducted. The JV agreement may also limit the use of the JV's name to avoid disputes between the members over the improper or unauthorized use of the JV name.

ii. Members

The agreement must specifically identify the members of the JV by their proper corporate names. This is especially important where one or more of the members has multiple subsidiaries or related entities that could easily be confused.

iii. Ownership Interests

The agreement must identify the ownership interests for each member. The corporate form of the JV will determine what form ownership interests take. For a partnership, ownership interests are typically represented by percentages of the JV. If the parties form a corporation, the ownership interests will usually be represented by number of shares. In an LLC, ownership interests can be represented by either shares or percentages.

iv. Bank Accounts

In order to operate its business, the JV will have to maintain a source of funds. To that end, the agreement must provide for the establishment of bank accounts in the name of the JV and identify who will establish the accounts, that all payments will be deposited into the JV accounts, and who will have the authority to draw on the JV accounts.

v. Licenses and Permits

Like any construction company, the JV will be required to have the necessary licenses and permits to perform work in the jurisdiction of the contract. The agreement should indicate whether the JV or one or more of the individual members is responsible to obtain the necessary license and permits to perform the work of the JV. The responsibility depends on the form of the JV. If the JV is a partnership, then one of the partners may be designated as responsible for obtaining the appropriate licenses and permits. On the other hand, if a new entity is created, then the JV will be responsible for obtaining the appropriate licenses and permits.

vi. Insurance

The agreement must have provisions on insurance, specifically, which member will provide it, the types of insurance, and the coverage each JV member will maintain to insure its own exposure for the project.

vii. Professional Services

The agreement should also identify the accountant, attorneys, and other professionals that will be used by the JV and how those professionals can be changed.

viii. Confidentiality

Another key to a successful partnership is open and candid communication between the members of the joint venture. In a JV, the members will often be required to disclose confidential and proprietary information about their respective businesses to one another. Therefore, the agreement should include a provision that ensures the proper handling and use of the disclosed information. The provision should describe what is considered confidential or proprietary and specify the procedures for handling and safeguarding the information.

b. Capitalization of the Joint Venture

i. Initial Capitalization

Virtually every JV will require initial capital—in the form of money, manpower, and equipment—to begin its operations. The JV agreement should thus carefully detail how the members will finance the initial operation of the JV. Often, the members will each contribute money to the JV, which will determine their respective ownership interests. However, JV members' contributions can also be nonmonetary, such as providing services or management staff to the JV. The agreement should identify each member's initial contribution to the JV. For nonmonetary contributions, the JV agreement should also assign values to the contributions to avoid any eventual disputes over the issue.

ii. Additional Capitalization

Ideally, every JV would immediately bring in sufficient income to cover its operational needs. In reality, though, that does not always happen. As such, the JV may require additional working capital to meet operational needs. This can either come from additional capital contributions from the members or from loans. The JV agreement must specify which financing mechanism the JV will use, who will make that decision, and under what conditions it will access that funding. Often the JV will create a budget at the outset that includes a contribution schedule so that the members can plan for contributions.

iii. Profits and Losses

Every contractor assumes the project eventually will be funded through profits received from the owner. If the project is going well, the profits should fund the job and be distributed to members once initial capital contributions are made. To determine the profits, however, the JV agreement must define how costs chargeable to the JV will be accounted for. The agreement should also lay out whether the JV will distribute earnings to the members or create reserves for future costs.

Accounting standards such as GAAP have definitions of JV profit and loss as well as standards for dealing with how and when contributed assets are recognized. They also define how to account for profits of the JV. A JV must discuss these issues with its accountant, but it cannot simply rely on outside conversations and definitions provided by GAAP. The agreement itself should contain definitions, which will help provide a clear and up-front understanding between the members.

The JV agreement should address when the JV distributes profit. Some JV agreements allow for profit distribution, at prearranged times, throughout the existence of the JV. Other agreements provide that all profits, with the exception of those necessary to cover taxes, be held until the project is complete. There are certainly good reasons for the latter policy. First, a member may be concerned that, unless profits are retained, it may have to rely on weaker financial members for capital contributions in the event something happens to reduce cash flow from the project. If profits are distributed too early, the difference in cash flow and capitalization can lead to disputes.

Second, companies hold profits because they are concerned about trust fund violations. Numerous states require payments received from a public owner be held in trust for the benefit of those who provide labor, materials, or equipment to a project. In some jurisdictions, courts have found a trust fund violation when a contractor takes profits in advance of payment of all amounts due or even those to become due subcontractors and suppliers. JV members should consider the law of the jurisdiction in which the JV is operating and account for it when drafting the JV agreement.

c. Operation of the Joint Venture

i. Purpose

The agreement must explain the objective or purpose of the JV. In the construction context, the agreement should state that the purpose of the JV is to perform and complete a specified project or series of projects. If the purpose is not specific, the JV could be considered a general partnership, which could result in joint and several liability for projects and matters unrelated to the specific and intended purpose of the JV.

Additionally, a precise description of the purpose is important to distinguish the activities of the JV from the activities of the individual members. Otherwise,

disputes between the members may arise over whether the JV usurped business opportunities of the individual members.

ii. Management

The key to the success of any business is strong management. This is especially true with a JV, given that the JV's leadership must bring together the parties' distinct management teams and styles. As a result, the agreement must lay out the method for management of the JV's business affairs. Typically, the agreement will create a management or executive committee that is responsible for the management of strategic (or big picture) business affairs of the JV. The agreement should specify how that committee will be chosen and operated.

The agreement should also specify whether decisions will require a unanimous vote or a majority vote based on each member's respective ownership interest. Ideally, all decisions would be unanimous in order to prevent disputes between the members over the propriety of the decision. Further, some accounting firms advise that, in order to meet the GAAP requirement for "joint control" necessary to be treated as a JV, all significant decisions of the JV require unanimous consent of all the members.

The day-to-day operations of the JV cannot be managed by a committee. Therefore, the management or executive committee will assign the day-to-day operations of the JV to a managing member or project manager. The agreement should spell out the scope and limits of the managing member's or project manager's responsibilities, along with the procedure to remove and replace the managing member or project manager if necessary.

iii. Provision of and Supervision over Manpower and Equipment

The JV agreement must define which party will provide skill sets, expertise, resources, manpower, materials, and equipment and how each will be provided. In addition to defining the cost to each member and how it is accounted for on the project, the JV agreement should detail which party supervises the labor and equipment. If one of the members has a specialty in one field, it may want to provide a particular person for that field and vice versa.

iv. Subcontracting and Rental from JV Members

Like any prime contractor, a joint venture will enter subcontracts and rent equipment to perform work on its projects. Sometimes the JV will subcontract work to or rent equipment from one of the JV member's business entities. This creates several issues, as the members should take steps in the JV agreement to ensure that any of these contracts are negotiated and entered fairly. For instance, the agreement should address the mandatory terms of the subcontract agreement, including the rates and conditions under which the JV will subcontract with a JV member.

v. Access to Joint Venture Books and Records

In order to monitor the financial conduct of the JV, the members must have access to the JV's books and records. The agreement should identify the books and records that are to be maintained by the JV, how long they will be maintained, where they will be located, and the procedure for accessing books and records. The agreement also should identify what reports will be regularly provided to the members and when those reports will be provided.

d. Disputes

i. Liability of Members

Liability of the JV members cannot be overlooked. This liability can take two forms. First is indemnification between members. When the JV is organized as a partnership, each partner is jointly and severally liable for the actions of the JV and the other partners. When the JV takes another corporate form, a similar risk exists that a single member may pay more than its share of a JV's liability. The parties should consider including an indemnification provision in the agreement that provides, in the event one JV member pays more than its proportionate share, that member is entitled to indemnification (reimbursement) for its overpayment. Parties also should take the appropriate steps to ensure that the indemnification provision is enforceable through personal or corporate guarantees.

The second form of liability that often arises in a JV is liability for the management of the JV, which is governed by the terms of the agreement. The business judgment rule typically protects the JV's management, shielding it from liability as long as its decisions were made in good faith, with reasonable care, and with the reasonable belief that it was acting in the best interests of the JV. Most often, the JV agreement will go a step further, limiting the managing member's liability to gross negligence or bad faith.

ii. Default Provisions

In addition to the management provisions of their agreement, JV members may have direct obligations to perform services or supply capital to the JV. If one of the JV members defaults on those obligations, the JV agreement should provide for what happens next. First, the JV agreement should define what constitutes "default." Second, the agreement should have a paragraph defining how notice of the default to the defaulting member is given and the period for the defaulting party to cure the default. Finally, the agreement should provide the consequences for default and a dispute resolution procedure. Typically, upon the occurrence of an uncured default, the defaulting member loses its rights in the JV (voting, profits) but remains liable for its proportionate share of any losses suffered by the JV.

iii. Dispute Resolution

Even with the most tightly worded and well-negotiated JV agreement, there is always a potential for disputes. Therefore, it is essential that the members include dispute resolution procedures that provide for fair, timely, and cost-effective dispute resolution in order to increase the chance of timely and profitable completion of the project.

Often, the members will dispute a particular action or strategy that requires unanimous consent—such as a capital call. This could lead to a stalemate and stall the work of the JV. Therefore, a JV agreement must have a tiebreaking mechanism. The agreement will typically give the chairman or managing member the ability to make a unilateral decision, which is then subject to an appeal procedure. In the case of a cash call, the appeal procedure may be referred to an accountant to determine the propriety of the call.

continued on page 32

Other, less critical decisions may require different dispute resolution procedures. Typically, the lead JV member or the project manager for the work is empowered to make the day-to-day decisions so the work proceeds uninterrupted. If one party disputes such a decision, the members should consider a tiered and expedited dispute resolution procedure so that the decision can be resolved in real-time. These procedures usually begin with mediation or facilitation to attempt to arrive at a consensual decision. If that does not work, the dispute resolution procedures usually escalate into binding resolution. These procedures should include the mechanism (that is, arbitration or litigation), the forum, the law under which the dispute will be decided, and the location of the dispute resolution proceedings.

e. Termination of the Joint Venture

i. Duration

Nearly every JV is limited to some extent—typically to accomplishing a specific purpose or completing a specific contract. The parties must, therefore, identify the events that will trigger the wind down of the JV. For example, the agreement may state that the JV will terminate if the JV is not awarded the contract or once the JV completes performance of a specific contract. However, the members must ensure that the agreement considers warranty obligations and the potential for latent defect and payment claims that may arise or continue after the completion of the contract.

ii. Early Termination

The JV agreement may specify how the JV may terminate early, in case one member is unwilling or unable to meet its obligations under the agreement. The withdrawal provision should prohibit a member from withdrawing without the approval of the other member, and potentially the owner and the JV's surety. The parties may also want to include a "buy-out" provision that permits one party to buy out the other's interest in the JV. One such provision permits one member to name a price at which it is willing to buy out the other member's interest. The other member then has the option to either accept the offer or to buy out the offering member's interest at that price. While this can be a useful provision when both parties have the resources to either pay the purchase price or complete the project alone, such a provision may take on a coercive element if one member lacks those resources. That is, the member with greater resources may be able to make an offer that it knows the other cannot meet, thus effectively forcing the poorer member to sell its interest at a price that may be unfair.

Additionally, the agreement should provide that the withdrawing member is not released from liability unless the other members agree in writing to release the member from liability. Even if the members agree to release the withdrawing member, that member may not be free from suit by the owner or surety.

iii. Wind-Down Process

The JV agreement should also set out the process that the members will follow when winding down the affairs of the JV. To that end, the parties should agree upon how assets will be distributed and who will do the distributing. This can be fairly straightforward if the JV ends at the time and in the manner the parties anticipate. In case the JV does terminate early, however, the JV agreement should contain provisions addressing the division of JV assets and allowing for either the termination of the JV's operations or the continued operation of the JV's business by the remaining member. The JV agreement should also address how the JV members will deal with any confidential information that they have acquired, along with how they will return to doing business in the area formerly occupied by the JV.

V. Conclusion

JVs can offer a range of benefits to potential members, but these benefits carry risks of liability both within and without the JV. For the sake of all members, these risks should be identified and addressed prior to the JV's formation. By carefully tailoring their JV agreement to the parties' particular needs, goals, and risks, potential JV members can minimize any misunderstandings as the JV is underway.

Be sure to read the authors' next article on JVs under U.S. Small Business Administration's programs, including the Mentor-Protégé Program, and special considerations for underwriting and bonding JVs, which will be published in the Spring 2021 issue of *Surety Bond Quarterly.*

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feature

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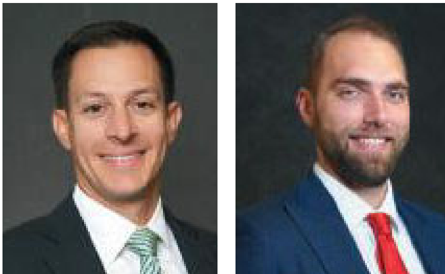
Joint Ventures in Construction:

Part 3 – Joint Ventures Involving the Federal Government's Small Business Programs

Sureties must beware of potential liability for violations of the Program's regulations.



BY MICHAEL C. ZISA AND
JOSHUA A. MOREHOUSE

Introduction

Parts 1 and 2 of this series explored the potential rewards and risks associated with joint ventures (JVs) in the construction industry and discussed key provisions of the joint venture agreement that the parties must carefully evaluate when considering a joint venture. Part 3 addresses special considerations for joint ventures involving the federal government's small or disadvantaged business program and potential liability for contractors, sureties, and bond producers for violations of the program's regulations.

Joint Ventures Involving the Federal Government's Small and Disadvantaged Business Program

One area in which JV relationships are particularly complex is in the federal government's Small Business Program. Under the Small Business Program, the federal government may set aside procurements for small businesses—meaning only businesses meeting the requirements of the program may compete for the contract.[1] Procurements may be set aside for any of the categories of small businesses: (1) small business; (2) small disadvantaged business (which includes the 8(a) program); (3) Historically Underutilized Business Zone (HUBZone) small business; (4) veteran-owned small business; (5) service-disabled veteran-owned small business; and (6) women-owned small business.

A. Limitations on Ability of Small Businesses to Affiliate with Large Businesses

Because many of the construction procurements that are set aside for small businesses are too large for a small business to perform on its own, small businesses often seek to partner with a large business to perform these projects. As discussed below, however, the Small Business Administration (SBA) places significant limits on the ability of a small business to joint venture with a large business to compete on set-aside procurements.

The SBA has established size standards for numerous classes of business for the purpose of determining whether a firm is small. The size standards vary based on the type of work performed by the firm. A firm may have more than one size standard if it does different types of work. The size standards are based on the North American Industrial Classification System (NAICS). The SBA publishes a table of small business size standards matched to the NAICS codes.[2] These size standards are either revenue-based or employee-based. The firm must have less average annual receipts or fewer employees than the size standard to qualify as small.

In determining whether a firm qualifies as a small business, the SBA will consider the size of the firm as well as its affiliates. The SBA will add together the number of employees or average annual revenues (depending upon the type of size standard that applies) of the firm and all of its affiliates in determining whether the firm is small.[3] "Affiliation" is a term of art used by the SBA to describe circumstances under which two or more businesses are so closely related as to be considered a single entity for purposes of determining whether the businesses are small. Firms are affiliates of each other when one controls or has the power to control the other, or a third party or parties control or have the power to control both. Firms can be affiliated through such things as common ownership, common management, financial support, bonding support, and subcontracting or other business relationships.

The SBA regulations define a joint venture as "an association of individuals and/or concerns with interests in any degree or proportion intending to engage in and carry out business ventures for joint profit over a two year period, for which purpose they combine their efforts, property, money, skill, or knowledge, but not on a continuing or permanent basis for conducting business generally."[4] Parties to a joint venture are usually considered affiliates if any of them seeks SBA financial assistance for use in the joint venture.[5] Thus, if a large business enters into a joint venture with a small business, the resulting JV will not be considered a small business and, therefore, cannot qualify to bid on set-aside contracts. However, as long as each of the members of the JV qualify as small businesses under the corresponding NAICS code, the JV may submit a bid as a small business.[6]

B. The SBA's Mentor-Protégé Program

If the procurement is set aside for small businesses, a JV between a large and small business is, therefore, usually not eligible for award of the contract. A limited exception to this rule exists, however, in the SBA's Mentor-Protégé Program.[7] An

BECAUSE OF THE POTENTIAL FOR SIGNIFICANT FINANCIAL REWARDS ASSOCIATED WITH THE SMALL BUSINESS PROGRAM, FIRMS HAVE ATTEMPTED TO CIRCUMVENT THE JV AFFILIATION RULE BY NOT IDENTIFYING THE OFFEROR AS A JV.

SBA-certified small business may, in some circumstances, enter into a JV with a large business and still be eligible to compete for contracts set aside for small businesses.

In order to qualify for the SBA's Mentor-Protégé Program, a small business must meet a number of requirements, including the size requirement in the applicable NAICS code and other requirements related to the business's ownership structure.[8] The SBA's Mentor-Protégé Program then permits another company (either large or small) to act as a mentor to a protégé. Two firms approved by the SBA to be a mentor and protégé under the Mentor-Protégé Program may enter into a JV and bid as a small business for any federal prime contract or subcontract.[9] The protégé still must qualify as small for the size standard corresponding to the NAICS code assigned to the procurement. In addition, the SBA has placed limits on the dollar amount of contracts received under its 8(a) set-aside program for small disadvantaged businesses before a firm becomes ineligible to receive additional sole source 8(a) contract awards. This limit has been set at $100 million.[10]

To participate in the Mentor-Protégé Program, both the mentor and the protégé must meet SBA's eligibility requirements.[11] They also must enter into a written agreement setting forth an assessment of the protégé's needs and providing a detailed description and timeline for the delivery of the assistance the mentor commits to provide to address those needs.[12] The agreement must be approved by the SBA's Associate Administrator for the Office of Business Development for the SBA District Office servicing the protégé.[13]

To joint venture, the mentor and the protégé must enter into a written JV agreement. The SBA has detailed regulations specifying what must be included in the JV agreement. These regulations include requirements regarding: (1) the ownership of the JV (the small business must own at least 51% of the JV entity); (2) the management of the JV (the small business must be the managing venturer); and (3) the performance of the contract (the JV members must perform at least 40% of the work and the small business must perform at least 40% of the work performed by the JV).[14] If the JV agreement does not contain these required provisions, the SBA may determine that the JV does not qualify for the affiliation exception (that is, the JV will be considered a large business).[15]

Whether the SBA must provide approval, the JV agreement depends upon the type of award on which the JV is bidding. If a JV is bidding on a sole source 8(a) award, the SBA must approve the JV agreement prior to contract award.[16] The SBA also must approve all amendments to the JV agreement.[17] For competitive awards, the regulations do not require SBA approval of the JV agreement. If someone files a size protest challenging whether the JV qualifies as a small business, however, the SBA will review the JV agreement to determine whether it complies with SBA's JV requirements. Once a JV has been awarded a contract, the JV may pursue additional contracts for a period of two years. While a JV is limited to two years under the SBA's regulations, the parties can form another JV at the expiration of that period. At some point in time, however, the SBA may conclude that the parties are affiliated, based upon a longstanding interrelationship or contractual dependence.[18]

Liability for Abuse and Fraud Involving the Small Business Program

Because of the potential for significant financial rewards associated with the Small Business Program, firms have attempted to circumvent the JV affiliation rule by not identifying the offeror as a JV. The typical scenario is for the small business to submit the proposal in its name and to identify the large business as a subcontractor—the ostensible subcontractor. The parties, however, may have a "side" agreement that provides in essence that they will proceed as a JV, that the large business subcontractor will control the JV, that there will be a split of profits and losses, and that the large business subcontractor will have some control over the contract proceeds through a joint check arrangement or otherwise. Such an arrangement can violate SBA's regulations[19] and lead to allegations of false claims or fraud.

Over the years, there has been a significant rise in both federal and state governments' prosecution of claims resulting from contractors attempting to use this type of scheme (and others) to circumvent affiliation. There is a presumption of loss to the federal government when a large business willfully seeks and receives the award of a contract or subcontract that was set aside, or otherwise classified as intended, for award to a small business.[20] The amount of the loss is the total amount expended by the federal government on the contract or subcontract. In other words, the federal

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government can assert that its loss is the entire amount of the contract and that the contractor's work had no value. In addition, the SBA's regulations specifically provide for penalties when a firm misrepresents its size status. These penalties include: (1) suspension or debarment; (2) penalties under the civil False Claims Act[21] and the Program Fraud Civil Remedies Act;[22] and (3) criminal penalties under the Small Business Act,[23] the False Statements Act,[24] and the criminal False Claims Act.[25]

Bond producers and sureties also must keep their eyes open for indications that contractors are attempting to circumvent the JV affiliation rules set forth in the previous section. Indeed, bond producers and sureties often have intimate knowledge of a contractor's business operations not only because of the underwriting process but also because of the long-standing and close relationship that can develop through years of working together. This relationship and knowledge can give rise to claims of fraud against bond producers and sureties. While the bond producer and surety generally will not be responsible for the acts of the contractors, liability could be imputed if the producer or surety knew or should have known of the contractors' plan or non-compliance with the governing regulations.

The potential for liability of bond producers and sureties associated with the federal government's small business program was illustrated in *United States* ex rel. *Scollick v. Narula*.[26] *Scollick* involved a *qui tam* (whistleblower) suit under the False Claims Act brought by Andrew Scollick (on behalf of the United States) alleging fraud against several government contractors.[27] Scollick alleged that these contractors had participated in a scheme similar to the scheme outlined above, in which the contractors had fraudulently obtained small business status. In addition to suing the contractors, Scollick also brought claims against their sureties, the bonding agency, and an individual bond producer (the Bonding Defendants).

Despite the Bonding Defendants seeking to dismiss the claims, the U.S. District Court for the District of Columbia eventually allowed Scollick's claims against the Bonding Defendants to proceed. In doing so, the court allowed for three potential theories of liability against the Bonding Defendants.[28] First, Scollick had alleged that the Bonding Defendants knew of the contractors' fraudulent scheme and nonetheless continued to do business with the contractors, thus enabling the contractors to submit additional false claims for payment to the government.[29] The court determined that the following allegations were sufficient to demonstrate that the Bonding Defendants "knew or should have known" of the fraudulent scheme:

- Bonding Defendants engaged in an underwriting process during which they conducted an on-site inspection of OST's offices, which made clear "that CSG was a shell company dependent on the resources and capabilities and capital of Citibuilders and OST and the experience and knowledge and financial backing of Parekh, Narula, and Madan."
- The underwriting and due diligence "would reasonably have revealed that CSG did not possess the necessary construction history or financial capabilities to carry out the scope of the contracting activity ultimately undertaken in the name of CSG."
- The underwriting and due diligence would have reasonably led to the conclusions that "Parekh, Narula, and Madan exerted dominance and control over CSG;" that "Gogia lacked the skill, knowledge, resources and past performance to engage in the scope of contracting activity undertaken by the CSG conspirators;" and that "CSG was not a service-disabled small business operating out of Harrisonburg."
- "The underwriting and due diligence by the Bonding Defendants to provide bonding to Citibuilders would have revealed that Goodweather was not in control of that entity and that Citibuilders constitutes a separate shell company Parekh established for the purpose of obtaining SDVOSB contracts."[30]

The court found these allegations sufficient to state a claim under the False Claims Act, emphasizing that Scollick had alleged sufficient facts that, if true, would demonstrate that the Bonding Defendants "knew or should have known" of the contractors' scheme and they perpetuated the scheme by continuing to assist with bonding.[31]

Second, Scollick had alleged that the Bonding Defendants had agreed to comply with the requirement that the funds for construction activities be paid to a small business; that the Bonding Defendants knew that the payments were not going to a small business; and that the Bonding Defendants therefore knowingly avoided their contractual obligation to compensate the government for the resultant loss.[32] Again, the court allowed this claim to proceed, focusing on the Bonding Defendants' alleged knowledge of the contractors' scheme.

Third and finally, Scollick had alleged conspiracy claims against the Bonding Defendants. The court held that Scollick's false claims allegations provided a sufficient basis to state claims for conspiracy between the Bonding Defendants and the contractors.

The *Scollick* lawsuit remains ongoing as of this writing.[33] It is, therefore,

unclear how these Scollick's claims against the Bonding Defendants will ultimately be resolved. However, *Scollick* shows us that bond producers and sureties can have exposure when assisting contractors with small-business set-aside programs. Again, the Bonding Defendants' liability has not been definitively determined yet, but this lawsuit has involved lengthy (and no doubt costly) litigation. No bond producer or surety wishes to expose itself to these costs based solely on the actions of the contractors that it bonds. As such, when working with businesses (including those contemplating JVs) involving small-business programs and contracts, bond producers and sureties must keep an eye open for any red flags that suggest wrongdoing.

Conclusion

Joint ventures involving the federal government's small or disadvantaged business program and the SBA's mentor-protégé program offer substantial opportunities and benefits for their members, opening doors to projects that contractors would otherwise be unable or ineligible to perform. However, these programs require strict compliance with the governing regulations, and failure to comply (whether inadvertent or deliberate) can have serious financial and even criminal consequences for contractors, bond producers, and sureties. Therefore, understanding the requirements and ensuring compliance is essential for all involved parties. ●

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End Notes

1 15 U.S.C. § 644.
2 The table is available at https://www.sba.gov/sites/default/files/2019-08/SBA%20Table%20of%20Size%20Standards_Effective%20Aug%2019%2C%202019_Rev.pdf.
3 13 Code of Federal Regulations (CFR) § 121.101. The CFR are rules published by the executive departments and agencies of the federal government.
4 13 CFR § 121.103(h).
5 13 CFR § 121.103(h)(1).
6 13 CFR § 121.103(h)(3)(i).
7 The SBA formerly maintained a separation between its 8(a) Mentor-Protégé Program and its All Small Mentor-Protégé Program. As of October 16, 2020, however, the SBA has consolidated the 8(a) Program with the All Small Program. This has effectively equalized the requirements of the two programs. See 85 Fed. Reg. 66146.
8 13 CFR §§ 124.101; 125.9.
9 13 CFR § 124.520(a).
10 13 CFR § 124.519(a).
11 13 CFR § 125.9.
12 13 CFR § 125.9(e).
13 13 CFR § 125.9(e)(3).
14 13 CFR § 124.513(c).
15 Size Appeal of Kisan-Pike, A Joint Venture, SBA No. SIZ-5618 (Nov. 24, 2014).
16 13 CFR § 124.513(e)(1).
17 13 CFR § 124.513(h).
18 13 CFR § 121.103(h). *See also* Size Appeal of Quality Servs. Int'l, LLC, SBA No. SIZ-5599 (Sept. 25, 2014) (mentor and its protégé were not affiliated when they formed eight separate JVs and were collectively awarded fifteen contracts from these JVs because the number of JVs and contract awards, while significant, were not sufficient to find general affiliation).
19 *See generally* Size Appeal of Analytical & Research Tech., Inc., Docket No. SIZ-91-8-2-96 (Dec. 19, 1991).
20 13 CFR § 121.108(a).
21 31 U.S.C. §§ 3729, *et seq.*
22 31 U.S.C. §§ 3801, *et seq.*
23 15 U.S.C. § 645.
24 18 U.S.C. § 1001.
25 18 U.S.C. § 287.
26 Case No. 14-cv-01339-RCL, 2017 WL 3268857 (D.D.C. July 31, 2017).
27 *See Scollick*, 2017 WL 3268857 at *2.
28 *Id.* at *3.
29 *Id.* at *14.
30 *Id.*
31 *Id.*
32 *Id.* at *15-17.
33 *Id.* at *17.

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