

Published in *Power Project Documentation, 2<sup>nd</sup> Edition*, May, 1999.  
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# **EQUITY, CONSORTIA AND JOINT VENTURE DOCUMENTATION**

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## **INTRODUCTION**

As is often the case in power project documentation, it is not a simple task to draft equity documentation to create a clear road map for dealing with all anticipated construction and operational issues. Participants may work tirelessly and at significant expense to negotiate precise provisions that appear to address perfectly all the issues that might arise, yet matters that were unforeseen at inception, such as changing business perspectives or conditions, cultural differences or changes in technology, may still cause problems later in a project's life. No one should conclude that proper contract language is a substitute for harmony in a joint venture or a cure for every conflict of interest. Nevertheless, proper choices in equity documents can go a long way in averting future relationship difficulties.

This chapter sets forth a general overview of the more important issues associated with the documentation governing the equity ownership of a power project company and suggests how they are best addressed. These issues are not matters of legal wordsmithing. Rather, they are the fundamental structural questions of how the risks and rewards of ownership are to be allocated. The chapter describes how the equity documentation reflects the key business choices that must be made by equity participants. It concentrates on the issues that tend to be of the most concern to both business persons and lawyers without attempting to discuss each and every legal issue that should be addressed by the documentation.

### **I. CHOICE OF ENTITY**

One of the first issues that a developer must address is the type of legal entity that will own the power project. (This entity is referred to elsewhere in this book as the "project company". This chapter necessarily makes use of other terms to differentiate between the structures that may be utilized.) The primary choices, and their relative advantages and disadvantages are discussed below. The significance of these advantages and disadvantages is likely to vary from developer to developer and from project to project. Approaches to considerations such as liability, management control and taxation will be greatly influenced by the ownership structure, legal status and tax status of the developer and the other parties investing in the project. Different parties may have divergent views as to what is most important, and consequent conflicts of interest will need to be reconciled if an enduring and harmonious structure is to be attained.

#### **A. Corporation**

The corporate form offers many advantages, not the least of which is the rule of limited liability, which provides that owners of a corporation are not personally liable for the corporation's debts. Corporations and other entities that share similar characteristics are widely used in many other jurisdictions throughout the world where there are well-developed bodies of law which allow the owners to define their relationships in a manner consistent with their investment goals. Corporate law in many US jurisdictions, such as the states of Delaware and New York, is highly developed and allows the owners a great deal of flexibility in structuring their relationships.

In many cases, a corporation will not be the vehicle of choice since it will be subject to corporate income taxes, that are generally separate from, and in addition to, income taxes paid by the owners of the corporation. Given the negative impact that the imposition of corporate-level taxes may have on the owners' return, the sponsors of a multiparty project are not likely to opt for the corporate form unless there is some way to avoid corporate-level tax or to obtain a credit against local taxes paid by the corporation. For example, in the US, a corporation that owns 80% of the voting rights and value of another corporation in the US can file a consolidated tax return with its subsidiary corporation. Filing a consolidated return will permit the consolidated entity to combine the income of a parent and its subsidiary corporation and pay taxes once on that combined income rather than pay corporate taxes at the subsidiary level and again at the parent level. In the case of projects located outside the US, the availability of a credit depends upon the local tax laws and the provisions of any relevant tax treaties.

## **B. General partnership**

Often the principal factor leading parties to choose a partnership structure is that in many countries a partnership is not subject to income tax. Rather, the income of the partnership is allocated to the partners that pay taxes on this income directly. This offers a distinct advantage over the corporate form in that it avoids the imposition of two levels of income tax.

Partnerships differ from corporations in other ways, some of which are not always favorable to the owners. For example, in a general partnership each partner is responsible for the debts and liabilities of the partnership. Sponsors may seek to minimize this risk and obtain the benefits of corporate limited liability by holding their partnership interests in the project company in special purpose corporate subsidiaries that hold no other assets. Under this scenario, the partners would be corporations with no assets at risk other than their partnership interests. The viability of this approach will depend on whether or not the parent entity can create a corporate subsidiary without creating a new level of corporate income tax liability. This is generally possible in the case of a parent which is a corporation organized under the laws of a state in the US. It may not be possible, however, if the parent entity is itself a partnership.

In many jurisdictions, partners have a right to participate in management. There may also be limitations on the ability of one partner to assign its management and other non-economic rights without other partners' consent. Although it may be possible to modify the statutory provisions with respect to management and limitations on assignment in the partnership agreement, doing so may endanger the entity's tax status and cause it to be taxed as a corporation. Accordingly, general partnerships are most appropriate for projects in which all the owners intend to participate in management. In those situations, the owners' mutual interest in knowing who the other co-managers will be may outweigh their interest in avoiding restrictions on the ability to sell their interests.

### **C. Limited partnership**

A limited partnership can be viewed as a general partnership with an additional class of partners, called limited partners. Limited partners differ from general partners in a number of important respects. Limited partners are not personally liable for the debts of the partnership, provided that they do not participate in the control of the partnership's business. Accordingly, under most limited partnership agreements, the limited partners have no right to participate in the management of the affairs of the corporation, although they may be granted the right to vote on certain significant partnership actions. (The granting of such limited voting rights to limited partners, if done properly, will not cause them to become responsible for the partnership's debts and liabilities.)

In many jurisdictions, a limited partnership must have at least one general partner whose rights and responsibilities are similar to those of partners in a general partnership. Thus, in a limited partnership, the general partners are commonly entities affiliated with owners that wish to have a role in managing partnership affairs. Because those entities face personal liability for the debts of the limited partnership, the general partners are often special purpose corporate subsidiaries. In many cases the only asset of a general partner is the minimum 1% interest in the limited partnership generally required for tax purposes. The owners of the general partnership interest often choose to hold the bulk of their economic interest (as opposed to management interest) in the limited partnership as limited partners. Thus, it is not uncommon for each developer of a project to own both a limited partnership interest as well as a corporate subsidiary that serves as the general partner of the project. Below is a chart showing an example of the ownership structure of a limited partnership with two sponsors in which ownership of the general partnership interests and the limited partnership interests have been separated.

The limited partnership is particularly appropriate for projects in which some of the equity is to be held by financial investors. Financial investors typically have no interest in assuming management responsibilities. Furthermore, they often have a greater desire for flexibility in selling their interests than sponsors that are more committed to playing an active role in the development of the project. Limited partnerships can separate the ownership of an economic interest in the project from management rights, thereby insulating the holders of the economic interests from personal liability. The well-developed state of limited partnership law in Delaware has made the Delaware limited partnership the vehicle of choice for many projects in the US. Outside the US, limited partnerships and other entities having similar characteristics offer comparable advantages.

### **D. Limited liability company**

In recent years, a number of states in the US (including New York and Delaware) have enacted laws creating a new type of entity called a limited liability company or "LLC". An LLC is essentially a hybrid entity, in that it incorporates certain characteristics of a corporation and certain characteristics of a partnership. As the name implies, an LLC provides its owners with limited liability, much like a corporation. LLCs, however, were created with the US federal tax laws in mind and, if certain guidelines established by the United States Internal Revenue Service (IRS) are followed, they will be treated as partnerships for US federal income tax purposes. In

this respect, US LLCs differ from their European counterparts, many of which are taxed in the same manner as corporations. The IRS guidelines require the LLC to adopt certain characteristics of a partnership, particularly with respect to assignability of interests and dissolution. The end result is an entity that looks very much like a general partnership with limited liability that extends to all members.

The US LLC is a relatively new creation. Although the first LLC law was enacted the 1970s, most states in the US did not enact them until the 1990s and in some states they still do not exist. It is possible that over time, as LLCs become more familiar in the legal and financial worlds, the LLC may become a more common vehicle of choice for power projects.

## **II. MANAGEMENT AND CONTROL OF THE PROJECT**

General partners in a limited partnership have a right to participate in the management of the partnership. Although the law permits the partners to vary this rule in the partnership agreement, it is common to grant management rights to each of the general partners and not to grant such rights to limited partners. The reason for this is fairly straightforward. Given that general partners have responsibility for partnership debts and liabilities and limited partners do not, any partner that is willing to give up a right to a voice in management generally would probably prefer to be a limited partner. Conversely, any partner that is willing to accept personal liability is probably willing to do so on the condition that it receive equal rights to participate in management.

### **A. Allocation of voting control among partners**

In limited partnerships in which there is only one general partner, the allocation of management responsibilities is fairly simple: the one general partner makes all decisions, other than any significant decisions that require a vote or consent of the limited partners (discussed below). Nevertheless, many limited partnerships have more than one general partner, and even those that start off with one general partner may adopt partnership agreements that are drafted to anticipate the possibility of multiple general partners.

One common approach is to form a board of managers made up of one representative of each general partner. Most decisions require the vote of the representatives of general partners holding at least 51% of the general partnership interests. Accordingly, in a partnership with only two general partners and with each holding equal percentage interest (that is, 1%), it would take the agreement of both to make any decision, since each individual general partner would hold only 50% of the general partnership interests. It follows that in partnerships with three general partners, two out of three would be sufficient to make most decisions.

Majority rule among general partners may be appropriate for most decisions that the board of managers may make. Nevertheless, there are often categories of significant decisions in project partnership agreements with respect to which a higher percentage of voting among general partners or even a vote of the limited partners would be required. For example, the partnership agreement may require a vote of general partners holding 66% or some greater negotiated percentage of the general partnership interests, together with a vote of limited partners

holding 66% or some greater negotiated percentage of the limited partnership interests, for the adoption of decisions regarding material project agreements, such as the agreements for construction of the project, the agreements governing sales of power or steam to principal customers and other significant contractual relationships. Other significant decisions relating to the raising of capital from partners, the borrowing of funds, the termination of the partnership and certain decisions that affect the partners' tax treatment may also be made subject to a higher percentage vote or a vote of limited partners.

### **B. Decisions involving affiliates**

Difficult issues among partners in a project often arise out of the other relationships that the general partners have with the partnership. Although a general partner itself is usually a special purpose entity, it is not unusual for affiliates of general partners to provide services to the partnership pursuant to separate agreements. For example, one of the affiliates of a general partner may construct the facility and another may provide day-to-day management pursuant to a management contract. In the case of a cogeneration facility, one of the general partners may be affiliated with the host that purchases power or steam from the project. In these situations, the partners may wish to build additional protections (beyond supermajority voting requirements) to ensure that the contractual arrangements between the partnership and parties affiliated with the general partners are made on an arms-length basis. Many partnership agreements provide that the votes of affiliated general partners are to be excluded in all decisions regarding contracts with their affiliates.

Provisions that exclude votes of affiliated partners must be carefully tailored to avoid unintended legal consequences. Questions of management and control of a partnership may be affected by matters other than the desires (and bargaining power) of the partners, such as statutes or regulations governing what type of entities are permitted to control power projects. In certain cases, prohibiting a partner from voting may create a potential conflict with such statutes or regulations. In the US, for example, for a project to qualify as a "qualifying cogeneration facility" under the Public Utility Regulatory Policies Act of 1978 (PURPA), it may not be controlled by an "electric utility" or an "electric utility holding company" (as such terms are defined in the relevant regulations). In other jurisdictions, local laws require local owners to maintain control or minimum ownership interests in order to qualify for preferential tax treatment, licenses or other governmental benefits that may be essential to the project's operation or financial success. In a partnership with one partner that is a foreign entity or another type of entity that is prohibited from exercising control, any provision that excludes the vote of any partner not so restricted (perhaps from transactions relating to affiliate arrangements, for example) could have the effect of giving the restricted partner a controlling vote for those transactions. Although the ability to cast a controlling vote under limited circumstances should not generally constitute control, the partners may wish to take the precaution of adding a provision allowing the partners, in the event of a legal challenge, to appoint a neutral party to vote the interest of the affiliated partner whose vote would otherwise be excluded.

### **C. Amendments to the partnership agreement**

Given the significance of the provisions of the partnership agreement itself, it is not uncommon for the partnership agreement to require a supermajority vote of the general partners to amend the agreement. In addition, in order to amend certain fundamental provisions, such as sections that set forth the supermajority voting requirements, the vote of 100% of the general partnership interests is often required. Partners will also usually seek to protect their rights to receive distributions by limiting the ability of the other partners to amend the provisions relating to distributions. This may be accomplished by requiring the vote of any partner whose distribution rights are adversely affected, unless the rights of other partners are affected in the same manner.

In some limited partnership agreements, even limited partners may be granted the right to vote on fundamental amendments, such as those affecting partnership distributions, although the breadth of the voting rights which the limited partners are able to negotiate will depend on their bargaining power. In partnerships in which all of the original limited partners are affiliates of general partners, it is unlikely that the limited partners will be given voting rights. Non-affiliated limited partners, however, may insist on being given voting rights in specific situations in order to protect their investment. Most limited partners (whether or not they are affiliates of a general partner) will also seek to include a provision requiring their consent to any amendment that would have the effect of making them general partners.

### **III. LIMITATIONS ON TRANSFERABILITY OF PROJECT INTERESTS**

A partnership agreement for a power project will generally contain restrictions on transfers of interests in the project partnership. These restrictions are intended to serve several purposes. First, and perhaps foremost, the parties investing in the project want to know:

- with whom they are doing business;
- that the other partners are capable of meeting their obligations to make capital contributions; and
- with respect to the general partners, that they have the type of expertise, experience and reputation that are likely to cause them to make intelligent decisions.

Consequently, it is not uncommon to require the consent of the general partners holding a majority, or even a supermajority, of the general partnership interests for the assignment of a partnership interest. In the case of an assignment by a general partner or by a limited partner, that is, an affiliate of a general partner, it is not uncommon to exclude the vote of that general partner for purposes of determining whether or not such consent has been given.

Assignments of partnership interests prior to the completion of the project and the payment of required capital contributions raise serious concerns for lenders as well as the other partners, since the assignees must be capable of meeting the ongoing equity commitments.

Accordingly, the ability to transfer a partnership interest during this period will often be more severely limited by the project financing documents and the partnership agreement. In many cases, the project financing documents will simply require the lenders' consent for any assignment of a partnership interest.

Once the project has been completed and all required capital contributions have been made, the theoretical need to limit assignments of limited partnership interests would not appear to be as great, given the absence of management rights associated with those interests. Nevertheless, many general partners have little economic interest in a limited partnership, and the economic interest that a general partner will seek to protect is the limited partnership interest held by an affiliated company. In order to ensure that the general partners (or their parent companies) retain a sufficiently real economic stake in a project partnership, the partnership agreement may place equally stringent limitations on the assignability of limited partnership interests as it does with respect to general partnership interests.

#### **A. Compliance with statutory requirements**

One specific purpose served by limitations on transfer is compliance with laws regarding ownership of the project. In order to prevent a project from losing a favored status under, for example, local ownership requirements or "qualifying cogeneration facility" requirements under PURPA, the partnership agreement may require each partner that proposes to transfer an interest to deliver an opinion of counsel that such a transfer will not cause the project to lose its favored status. Alternatively, it may simply rely on general provisions requiring the consent of a certain percentage of the general partners to an assignment on the theory that such consent will not be given unless the general partners are comfortable that the transfer will not endanger the project's status. Such provisions may be essential in order to ensure compliance with laws limiting foreign ownership or other restrictions arising under applicable law.

Restrictions on transfer that are designed to meet statutory requirements may serve to limit one party more than another. The parties may seek to reallocate this burden through contractual provisions. An example of this is in the box below.

A partnership formed to build and operate a project that is owned (indirectly) by two entities, ABC Corp. and XYZ Corp. ABC Corp. is a type of entity that under applicable law is not permitted to own more than 50% of the voting interests in the project (a "restricted entity") and XYZ Corp. is an entity that faces no such restriction (a "non-restricted entity"). Each of the two entities holds (through one or more different subsidiaries) a general partnership interest of 1% and a limited partnership interest of 49%. Assume that another restricted entity is interested in purchasing an interest in the project. Only ABC Corp.'s subsidiaries can sell their interests to the potential buyer; XYZ cannot, since any sale by XYZ to such a buyer would cause the project to be owned more than 50% by a restricted entity. Since XYZ's market for a secondary sale is more limited than ABC's, XYZ could attempt to negotiate with ABC a provision requiring that ABC share with XYZ some benefit from any sale by ABC to a restricted entity.

Another reason for limiting transfers of partnership interests is the need to ensure that the partnership remains a partnership for tax purposes. One of the characteristics that distinguishes

partnerships from corporations under the tax laws of many countries (including the US) is the inability of the partners to transfer their interest freely the way that corporate shareholders are generally able to do. Accordingly, it is common for partnership agreements to require the consent of the general partners (or general partners holding a majority or supermajority of the general partnership interests) to any assignment of a partnership interest, whether general or limited. Furthermore, some agreements also require delivery of an opinion of counsel that the proposed transfer will not have any material adverse tax consequence on the partnership or the partners.

### **B. Change in ownership of partners**

Any change in the ownership of individual partners (or parent companies) raises many of the same concerns associated with a direct sale by the partners of their partnership interests. Issues such as the creditworthiness of the partners, ability of general partners to carry out management functions, eligibility under regulatory schemes, and even preservation of tax status can be affected by sales of equity in the partners or upstream sales in the same manner as if the partners themselves sold their partnership interests. Since most partnership interests are held by special purpose entities, any partnership agreement that attempts to limit transfers and assignments of partnership interests without placing similar limitations on transfers of the equity of the partners or upstream parents may leave partners exposed to a large loophole.

In order to address these concerns, many partnership agreements contain provisions that deem sales of equity interests in the partners or their parent entities to be the equivalent of sales of partnership interests. The scope of these provisions may vary, depending upon the project and the nature of the partners or the parent entities. Sales of non-controlling equity interests and sales of equity interests of publicly held parent entities are frequently excluded. Whether the partners will be concerned only with equity sales that amount to changes of control or whether they wish to limit all changes in ownership may vary with the circumstances. Sales of non-controlling equity interests may not raise concerns with respect to statutes or regulations that only limit what parties can control the project, but they may raise concerns as to the seller's commitment to the project.

### **C. Rights of first refusal**

One form of limitation on transfers that can be found in some partnership agreements is a right of first refusal. Under a typical right of first refusal provision, a partner seeking to sell all or a portion of its interest to another party must first give the other partners the right to purchase the interest at the proposed purchase price. If the other partners do not exercise their right of first refusal within a specified period of time, then the seller may complete the sale to the outside party. Typically, the time period during which the sale to the outside party may take place is limited and, if it does not occur within that time, the process must be repeated.

Many developers and investors object to first refusal rights on the grounds that no outside party is likely to be willing to spend time and money negotiating a purchase of a partnership interest if it believes that the other partners will take the deal away by exercising their right of first refusal. To address this concern, the agreement could require that the right of first refusal be exercised at a slightly higher price than the proposed selling price, for example, 105%. A seller

can offer a potential purchaser a break-up fee of some or the entire 5% premium that it will receive if the right of first refusal is exercised as compensation for the time and expense spent in negotiating the transaction. Another way is to grant any seller a reasonably lengthy period after the right of first refusal is not exercised to complete the sale. This would permit a seller to negotiate a preliminary price with an outside buyer (subject to due diligence), offer the price to the other partners and, if they refuse, go back to the outside buyer unencumbered by the right of first refusal.

#### **D. Right of first offer**

Another option that some developers and investors find attractive is a variant of the right of first refusal known as a right of first offer. Under a right of first offer provision, the partner proposing to sell an interest must first offer the interest to the other partners at a proposed price. If the other partners decline to purchase at that price, the partner seeking to sell would thereafter be free to sell such interest during a specified period to an outside party at the price offered to the other partners or, in some cases, at a price that may be slightly lower, such as 90% or 95% of the offer price. This arrangement eliminates the uncertainty as to whether the other partners will exercise their rights. Flexibility to lower the price also makes it easier to negotiate with potential buyers.

### **IV. DEFAULTS**

Parties enter partnerships to build and operate power projects with the expectation, or at least the hope that their partners will not default on their obligations. Nevertheless, defaults are a commercial reality. Accordingly, every partnership agreement should specify what actions constitute defaults and what the consequences of a default will be. It should also specify any notice and cure periods that must be triggered before a default is deemed to have occurred. Spelling these matters out specifically protects the non-defaulting parties by enabling them to take action against the defaulting party and also protects the defaulting party by eliminating overly draconian remedies.

#### **A. Types of default**

The most common default under a partnership agreement is the failure of a partner to make required capital contributions. As described above, the lenders providing the project financing are likely to insist that any partner's commitment to make capital contributions be supported by appropriate credit enhancements. The stronger the protection that the lenders have obtained, the lower the likelihood of a default of this type. Should a default occur however the other partners should have the right to take action against the defaulting partner. Similarly, the partnership agreement should also specify that a breach of any other significant provision of the agreement will constitute a default. Otherwise, the partners that have complied with the agreement may be left with no remedy against one that has not. The other types of defaults that are commonly found in partnership agreements relate to changes in the status of a partner that could have an adverse effect upon the partnership. For example, bankruptcy of a partner will usually be a default. In addition, if the partnership's legal status or any significant commercial or financial advantage (such as eligibility for partnership tax status, or local ownership

requirements) are dependent upon the partners maintaining a certain legal status, a well-drafted partnership agreement will make the failure of any partner to maintain such status a default.

### **B. Remedies against a defaulting partner**

Default provisions, of course, are only significant to the extent that the non-defaulting partners are given sufficient remedies against the defaulting partner. One of the most important remedies is the ability to force a partner out of the partnership by requiring it to withdraw or sell its interest. In some instances, forced sale or withdrawal is the only remedy that will protect the other partners, and the partnership as a whole, particularly in situations in which the defaulting partner's status has caused, or threatens to cause, a serious adverse impact on the partnership. A forced sale provision would usually enable partners to force out any defaulting partner regardless of whether or not the circumstances of default were within that partner's control.

In forced sale or withdrawal situations, the right of the partners that have not caused the default must be balanced against the right of the defaulting partner to cure the default or to receive fair consideration for its interest in the partnership, taking into account the circumstances. Accordingly, the agreement must specify a formula for determining the amount that the withdrawing partner is to be paid. In many cases, the formula is based on a percentage of market value of the partnership interest (as determined by an agreed-upon person or method) and will often vary depending on the cause of the forced withdrawal. It is important that the sale or withdrawal be able to take place immediately and not be made subject to the making of the payment to the withdrawing partner. Accordingly, the partnership agreement should permit the partnership to pay the departing partner in the form of a promissory note. Furthermore, if a new partner is found to purchase the departing partner's interest, the new partner should also have the ability to pay with a note. Any note issued by the partnership will need to be subordinated to any project financing obligations, or else the ability to pay the partnership's obligations with a note could be of no value: a non-subordinated note would rarely be permitted under the documents governing the project financing.

The non-defaulting partners may not wish to exercise, or as a practical matter be unable to exercise, a right to force a sale or withdrawal in every instance. Accordingly, it is important that there be other sanctions against defaulting partners, the most important being the suspension of any right to receive partnership distributions and the right to vote or otherwise participate in partnership decisions (to the extent that the defaulting partner had any such right). In some situations these remedies can take effect automatically. For example, the partnership agreement can deem the partnership to have lent the amount of all unpaid contributions to any defaulting partner and require that any future partnership distributions owed to that partner be offset against its obligation to repay the loan. This has the effect of preventing a partner that has failed to make required capital contributions from receiving its share of partnership distributions until all such required payments have been made.

In addition to provisions that allow other partners to force a defaulting partner to withdraw from the partnership, many partnership agreements permit other partners to remove a general partner as a general partner and convert its interest to a limited partnership interest in certain limited circumstances, such as fraud, criminal liability or material breach of the

partnership agreement (or specific terms thereof). This type of provision enables the other partners to protect themselves against a general partner's manifest malfeasance by stripping it of its management rights. This right may be given to the limited partners or, if there is more than one general partner, it may be limited to the other general partners.

The ability to force other partners out of the partnership or remove general partners is not intended to be used lightly. In many jurisdictions, partnership law requires every partnership to have at least two partners and every limited partnership to have at least one general partner. Thus, expulsion of a partner from a two-partner partnership or removal of a sole general partner may force a dissolution of the partnership, unless another entity can be brought in to take its place.

## **V. FINANCING THE PROJECT**

Some of the more critical provisions in any project partnership agreement are those contemplating the financing of project costs during development, construction and operations. Once the sponsors have finalized the project's structure and have agreed on their relative ownership percentages, partnership agreements will generally require that any capital required by the partnership is to be provided by the partners in accordance with those percentages.

Partners will usually agree to provide financing for all development costs (including internal and third party costs) in accordance with an agreed set of procedures set forth, for example, in a development budget and schedule. Such financing will usually be in the form of contributions of capital or loans to the partnership repayable at construction financing closing.

For the typical project financing, the project partnership will solicit construction loans, permanent financing and other loans, or issue debt or equity securities to financial institutions or to the public, to finance the purchase or lease of the project site and the construction or improvement and operation of the project. As part of the project financing process, the partners in the project will obligate themselves to each other and to their financiers to contribute as capital, pro rata in accordance with their ownership percentages, a portion (up to an agreed cap) of the projected or actual capital cost of the project set forth in the project budget developed and approved by the partners and the lenders. In addition, partnership agreements may also include commitments by partners to contribute cash to the project partnership or make loans to the partnership, pro rata in accordance with their ownership percentages, in amounts sufficient to fund deficiencies in working capital or unscheduled maintenance, repairs or replacements, although limits and caps on such commitments will almost certainly be the subject of a fair amount of negotiation between partners, and by the partnership with lenders.

Project partnership agreements usually address the consequences between partners of the failure by a partner to make any required capital contribution or loan. Typically, penalty interest at some above-market rate will accrue on the defaulted amount, and the non-defaulting partners will retain the option to make the requisite contribution or loan on behalf of the defaulting partners. Exercise of this option will more often than not be deemed to constitute a loan to the defaulting partner by the non-defaulting partner or partners. During any period that this loan is outstanding, the typical project partnership agreement will provide that distributions to, or sales of partnership interests by, the defaulting partner are prohibited or, in the alternative, that any

payment due the defaulting partner, including distributions or sales proceeds, first go to the non-defaulting partner to pay off the loan. The defaulting partner may also be blocked from voting on matters coming before the board of managers and could become subject to forced withdrawal from the partnership.

Closely related to commitments among partners as to capital requirements are commitments to lenders. In a typical project financing, the lenders will require as a condition to extending credit that the project partners commit to invest a minimum amount of capital in the project. Any forward-looking commitments would be evidenced by a capital contribution or similar agreement among the lenders, the project partnership and the partners. The original commitment would adjust over time by the aggregate amount of contributions actually made and would be subject to an overall cap. The typical capital contribution agreement will include a schedule for draws on any unfunded equity commitments as well as any special rules for prioritization between draws of debt under the core financing agreement and of equity from partners. The capital contribution commitment may also be subject to acceleration upon the occurrence of certain events, such as events of default in the credit documentation or the occurrence of some outside date before which the project committed to have commercial operation occur.

To support the payment and performance of each partners' obligations under the capital contribution agreement, lenders will require credit support from creditworthy entities for any forward-looking equity commitments. It would be to these arrangements that the lenders would look in the event any partner failed to contribute any required capital. Examples of such credit supports include letters of credit, parent company guarantees, or cash collateral or escrow arrangements.

## **VI. TAX ASPECTS**

Tax considerations play an important role in structuring ownership of the project and in drafting many of the specific provisions of the governing document. Although the potential availability of a foreign tax credit may mitigate the burden of taxation of income at the project level, as indicated above, one of the principal drives in structuring projects as partnerships (or as limited liability companies in jurisdictions where they are treated as partnerships for tax purposes) is the desire to avoid taxation of project income at the project level.

Maintaining partnership tax status is not simply a matter of adopting a partnership or limited liability company format. Specific sections of the partnership agreement must be drafted in a particular manner so as to obtain that goal. For example, as a general rule, items of income and loss are allocated among partners in accordance with their ownership interests. Nevertheless, it may be necessary to vary that rule in certain instances, such as for international projects to satisfy applicable tax laws and treaties in more than one country or in order for a project to comply with various United States Treasury or other applicable regulations. Furthermore, the partnership agreement must contain provisions setting forth how the partnership will make certain elections and other determinations that must be made for tax purposes.

A full discussion of the tax issues that must be considered in a partnership agreement is outside the scope of this chapter, and tax is dealt with more broadly in Chapter 7 - Dealing with Tax Documentation. Clearly, it is very important that tax counsel review the partnership agreement at every stage in order to avoid unintended results.

## **VII. RESOLUTION OF DISPUTES**

Partnership agreements for power projects typically contain arbitration clauses. The purpose of these clauses is to require the parties to settle disputes before arbitrators rather than courts of law. Arbitration can be a more efficient and flexible means of resolving disputes than litigation. An arbitration clause will specify the number of arbitrators, how they are appointed and the general rules under which they are to operate.

Arbitration clauses are particularly significant to partners investing in projects overseas together with local parties. Foreign investors are likely to worry that the local tribunals will favor the local party in the event of a dispute, whether or not such a fear is well grounded. In order to minimize the risk of local bias, the foreign investor may insist that the agreement require that one or more of the arbitrators be from a country that is viewed as neutral. Alternatively, the agreement may require arbitration before a recognized international organization, such as the International Chamber of Commerce (ICC) or the London Court of International Arbitration. If that is not possible, either because of the bargaining leverage of the local party or the requirements of local law, the foreign investor may need to rely on a provision requiring arbitration before a local business or professional organization that is likely to have an interest in promoting foreign investment, such as a chamber of commerce or bar association, if such an organization is available.

In any event, the agreement should specify general guidelines to be followed by the arbitrators. The rules of the body from which the arbitrators will be selected or before which the arbitration will take place may specify procedures for arbitration or they may permit the parties to elect other procedures. For example, the ICC and the American Arbitration Association (AAA) have their own procedural rules, although in certain situations they may permit the parties to agree to variations of such rules. In addition, the United Nations Committee on International Trade Law has promulgated a set of rules specifically designed for ad hoc arbitration tribunals. If appropriate rules can be agreed upon in advance, they can be adopted by reference in the arbitration clause.

Foreign investors relying on arbitration clauses to avoid litigation in local courts need to consult with local counsel to make certain that these clauses are enforceable in the jurisdiction in which the project is located, as well as any jurisdiction where another partner is organized. In the US, a properly drafted provision requiring the arbitration of all disputes will generally be upheld against any party that seeks to initiate litigation; however, the laws of other countries may be not be as favorable to mandatory arbitration clauses.

A type of arbitration provision that is commonly found in US partnerships (with numerous variations) is one that provides for matters to be decided before a panel of three arbitrators in accordance with the rules of the AAA. Under this type of provision, each side

appoints one of the three arbitrators and the two arbitrators appointed by the parties select the third one. If the first two arbitrators cannot agree on a third arbitrator, AAA chooses the third arbitrator.

### **VIII. OTHER PROVISIONS**

A complete and well-drafted partnership agreement includes many provisions in addition to those described above. For example, most power project partnership agreements will contain a purpose clause specifying that the purpose of the partnership is to build and operate a specific type of project at a specific location. The partnership agreement should contain representations and warranties of the partners with respect to their power and authority to enter into the agreement and any other matters that are of concern to the other partners, such as the legal and regulatory status and ownership of each partner. Provisions requiring the partnership to indemnify general partners against losses incurred by the general partners in connection with acts taken on behalf of the partnership are fairly standard, as are provisions requiring partners that breach the agreement or act in bad faith to indemnify other partners from losses arising from such actions.

A well-drafted project partnership agreement will usually specify that any excess cash of the partnership (defined generally as the excess of all cash receipts of the project from all sources over the sum of all cash disbursements, required working capital commitments (except to the extent funded by debt or other sources) and any special reserve requirements) will be distributed to partners on a periodic basis, pro rata in accordance with their respective ownership percentages. The typical agreement will also contain provisions governing dissolution and winding up of the partnership as well as certain accounting matters. Although these provisions tend to contain mostly boilerplate language, it is important that they be reviewed carefully by counsel, particularly tax counsel. Failure to include certain standard provisions with respect to these matters may jeopardize the partnership's tax status or cause other unintended legal consequences.