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Taking Security Over Joint Venture Interests

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SUMMARY

This paper analyses security in multi-party unincorporated joint ventures and briefly compares the position with respect to partnerships and so-called incorporated joint ventures. The main focus is security requirements for unincorporated joint ventures in the context of project financing. In this regard, the paper discusses the relationships of the parties, the specific assets that may be subject to the security, and the ways in which the terms of the joint venture agreement might affect the security position. The relationship of parties and their protection from risk of funding default is also discusssed. Finally, the paper considers recent topical financing issues in the context of unincorporated joint ventures, such as leveraged acquisition financing of resources companies, and situations where a joint venturer acts as an arranger of finance for one or more other joint venturers.

1. INTRODUCTION

1.1 Background

In 1988, Robert Milliner delivered a paper at the AMPLA Western Australian Branch Conference entitled "Taking Security Over Joint Venture Interests".[1] Over the years, we have lost track of the number of times people have asked us whether we had copies of that paper. We therefore thought it would be time to take a fresh look at it. Milliner's paper focused on all of the issues facing joint ventures at that time: project financing issues, taking security generally as well as the specific issues affecting security over interests in joint ventures. Since Milliner's paper, much has been written about project financing and taking security generally but far less about taking security over joint venture interests specifically.

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1 R Milliner, "Taking Security Over Joint Venture Interests" Paper presented at the 1988 Australian Mining and Petroleum Law Association Limited (WA Branch) Conference, Session No 2 Paper 5.

We therefore propose to focus on issues affecting the taking of security over joint venture interests specifically. The importance of taking effective security over joint venture interests will vary according to the situation, but in some cases (such as project financing scenarios), it will be critically important.

In considering this issue, it is also necessary to consider the extent to which the law recognises, or at least does not prohibit, the concept of an Australian unincorporated joint venture. After all, if the law were to hold that the legal relationship of the parties was something other than that for which they have bargained (for example, that the legal relationship created in fact constituted a partnership), the financier may well have taken a different security than that which they were expecting.

1.2 The Australian Unincorporated Joint Venture for Minerals

We propose to focus on the Australian unincorporated joint venture for the production of so called "hard rock" minerals. The reason for this is that, given the nature of our analysis, we will need to focus on the provisions commonly found in joint venture agreements. Australian joint ventures for the production of oil and gas are in many respects similar to "hard rock" joint ventures, but carry with them different concepts arising from the nature of the product (such as unitisation and there are other significant issues, such as legislative production directions). Such concepts alter our analysis in a way which given the constraints of time and space, is beyond the scope of this article.

Further we will not consider the taxation or stamp duty issues associated with joint ventures, or their financing. We will therefore not consider some of the more innovative techniques currently in vogue for mitigating stamp duty liabilities.

1.3 Some Context

The degree to which issues associated with taking security over joint venture interests specifically needs to be considered will depend on the nature of the financing. If, as is often the case in corporate financings, joint venture interests form a small or immaterial part of the group, lenders may be willing to simply forego taking security over joint venture interests, notwithstanding that the financing is otherwise fully secured.

Such a situation would obviously be unsatisfactory in a project financing of the construction and operation of the joint venture project, or the acquisition of a joint venture interest, where the primary security is that joint venture interest. In those circumstances, other security is likely to be merely ancillary to the joint venture interest: for example, product and sales contracts (which, traditionally, are considered not to form part of the joint venture interest) and bank accounts in which the sales proceeds are held.

This situation is also likely to be unsatisfactory in a leveraged acquisition financing (or a secured corporate financing) where one or two joint venture interests contribute a significant portion of the value of the company being acquired or being financed. We will return to this question in section 7.

However, as the project financing of the construction and operation of a joint venture interest requires the most rigorous analysis of the nature of the security to be taken over the joint venture interest, we will devote most of this paper to discussing security in that context. As such, notwithstanding that it is not our intention to focus on project financing generally, we have included a brief outline of its principles.

1.4 Project Financing

The term "project financing" is often used in the industry to denote specific types of financing. Rather than spend time trying to define project financing (there have been many attempts over the years), we thought we would identify some of its key features, with a view to placing the rest of the paper into context:

(a) A person or persons wishing to conduct a project (the "sponsors") will wish to limit recourse to their non-project assets for liabilities associated with the project. These days, a sponsor will normally do this by utilising a special purpose project vehicle with a view to quarantining the risks associated with the project in the project vehicle. We will leave aside the possibility of a substantial company entering into a project financing on the strength of contractual limited recourse provisions – such situations do not arise as often they may have done in the early days of project financing in this country. Amongst other reasons, this is because financiers are concerned about administration risk, as to which, see section 6.3. From a sponsors' perspective, the use of a separate entity is safer. Recourse to non-project assets will only be had when the corporate veil is pierced. Where recourse is limited contractually, recourse may be had to the non-project assets to the extent the provisions do not guard against all present and future avenues of attack. The advent of tax consolidation has reduced the need to house projects within the same entity as other businesses and this has reduced the need to take this risk.

(b) Sponsors will contribute equity funding to the project. This can be done in a number of ways (eg subscription for ordinary or preference shares or provision of subordinated loans). Equity contributions can even be "back-ended" – that is, deferred for a period, say to the completion of the construction phase. Project financiers may be willing to accept this position if an "equity bridge facility" is in place – that is, the "equity" is provided initially as a loan from the equity bridge financiers. To give the project financiers comfort that such loan is as good as true equity from a security perspective, that loan is generally supported by letters of credit or cash equivalent instruments.[2]

[2] See P Doyle, "Project Finance: Issues for Project Sponsors and Project Contract Counterparties" [2003] *AMPLA Yearbook* 84, 95-97.

(c) Debt will be incurred at the project vehicle level (leaving aside any equity bridge funding). The sponsors will seek to ensure that debt will be repaid out of the cash-flows generated by the project and that, in the event of a default, the only recourse of the financiers will be against the project vehicle personally, and the assets of the project. In doing this, the sponsors' aim is to keep their non-project assets immune from a default at the project level (so far as is allowed within the commercial constraints of the transaction).

(d) The debt documentation will contain terms having the following effect:

  (i) If the project requires construction to be undertaken, there may be a construction facility, where drawings are allowed upon achievement of a particular milestone, and satisfaction of a cost to complete test at that time.

  (ii) Cash flows generated by the project are required to be paid into a bank account (often designated as the "operating account"), and withdrawals from the bank account are only allowed for permitted purposes. These permitted purposes would include operating costs, debt service, certain kinds of capital expenditure (for example, non-discretionary capital expenditure, or capital expenditure up to a limit). Distributions to sponsors would only be permitted once certain milestones are met.[3] In addition, in more sophisticated financings, there may be an array of dedicated project accounts required by financiers (for example, an account into which insurance proceeds are deposited (with special conditions attaching to the release of such proceeds) and reserve accounts in which minimum balances must be maintained for the purposes of say, debt service, or anticipated maintenance expenditure).

  (iii) There will generally be a financial covenant under which the project vehicle will undertake to ensure that a particular level of cash is available for debt service (DSCR). The DSCR is normally calculated for a 12-month period and may be based on past (actual) figures or future (forecast) figures. There will also generally be requirements to maintain the ratio of forecast cash flow over the life of the project (or the loan) to debt service obligations over that same period, above a particular level. In mining projects, there is also likely to be a physical ratio, for example, a requirement to maintain reserves scheduled to be mined after the last debt repayment is made, above a particular level. See P Doyle "Project Finance: Issues for Project Sponsors and Project Contract Counterparties" for further discussion of the types of financial covenants appropriate for a project financing.[4]

  (iv) There will be covenants requiring the project vehicle to construct and operate the project in a particular way, not amend major contracts

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3 Following the Privy Council's decision in *Brumark Investments (In Receivership)*; *Agnew and Ors v Commissioner of Inland Review* [2001] 2 AC 710 *(Re Brumark),* there are difficulties with ensuring any security over such bank accounts operates as a fixed charge. These issues have been well documented: see eg Y Cho, "The Fixed and Floating Charge" in Mallesons Stephen Jaques (ed), *Australian Finance Law*, (5th ed, 2002).

4 [2003] *AMPLA Yearbook* 84, 95-97.

(such as construction contracts) without the consent of the banks, and to conduct relationships with contractors in a particular way. These clauses afford financiers a measure of control over the project.

(e) The financiers will normally seek to take security over all of the assets of the project vehicle (unless the cost of taking the security far outweighs the benefits of doing so). In a mining project, those assets the subject of the security will include the mining tenements, fixtures, equipment, rights under agreements (including any state agreements), product, sales contracts and proceeds of sale, and rights under insurances. The purpose of the financiers taking such security has been the subject of much discussion.[5]

In a default situation, particularly prior to completion of the construction phase of the project, the realisation value of the project (or the assets, if the project cannot be made to operated successfully) may be far less than the debt provided. After all, any prospective purchaser will be acquiring a construction site so the value of the project to that purchaser is likely to be discounted to reflect the uncertainties associated with determining both the status of the site and the project more generally, the cost to complete the project, and the likely timing of the first revenues generated by the project. Any receiver appointed by the financiers will find themselves in a similar position. In both cases, as compared to the borrower, the purchaser or receiver will have the added disadvantage of a lack of actual experience in managing the specific project.

Nonetheless, the security will provide the financier with certain defensive benefits. These include:

(i) ensuring that nobody else obtains equal, or better security, (other than under the cross charge (as described in section 3.2 below) and

(ii) if security is taken over all, or substantially all, of the assets of a company, ensuring that the financier may enforce its securities, notwithstanding that an administrator has been appointed.[6]

The security will also provide the financiers with a better bargaining position in the event that it needs to reach a compromise with the company, for example, in a work-out, an administration, or in a creditors' scheme of arrangement.

In cases, where a project is operating and producing at the levels anticipated at the outset of the project, the security may have positive benefits (as there may be a significant realisable value associated with the project). Although it is unlikely that in such circumstances a default would have occurred, it is not impossible. For example, in the Pasminco and Sons of Gwalia insolvencies there were extensive liabilities associated with hedging arrangements while the underlying projects were cash flow producing, and in some cases, relatively profitable. In such circumstances, a new entity not burdened with those liabilities might be able to pay a price for the project sufficient to satisfy the outstanding debt. On the other hand, if the default has been caused by a fall in the price of the particular commodity, the

[5] See, for example, Milliner, op cit n 1, 16-17 and Doyle, op cit n 2, 108-09.

[6] *Corporations Act 2001* (Cth), Pt 5.3B, Div 7 and see section 6.3 of this paper.

market price of the project may be insufficient to meet the debt, notwithstanding that the project is healthy in a physical sense.

Given the limitations of project security, financiers normally seek to water-down, the limited recourse principle, by insisting on some form of sponsor support, at least until the time at which the project is producing at a level capable of servicing the project debt. The forms of sponsor support, and the times at which such sponsor support is released, can be many and varied, and can range from payment guarantees, to direct completion undertakings (where the financier's remedy is to sue for breach of undertaking, with the associated difficulties of establishing breach and loss, taking into account causation and mitigation) to offtake contracts (in which the sponsor or a related entity is required to start acquiring product from a fixed date, regardless of when it is delivered). Milliner said of the commercial situation in 1988:

> "Many loans are structured on the basis that recourse is unlimited during the pre-completion phase (at which time the lender is at greatest risk – having security over a partly completed project is not of great benefit if default occurs at this point) and that in the post-completion period, following completion of a rigorous performance (or commissioning) test, recourse is limited."[7]

These days, it is probably no longer correct to say that recourse is "unlimited" particularly where a special purpose project vehicle is used (in such cases, the issue is what recourse can be had to the sponsor and as we have seen, the forms of sponsor recourse are many and varied). However, the key commercial principle remains the same: financiers are exposed to significant risk prior to the project operating at a commercial level, and their risk is reduced if recourse can be had to assets outside of the project, prior to that time, notwithstanding that this is contrary to the limited recourse principle.

2. THE CHOICE OF PROJECT VEHICLE AND THE POSITION OF FINANCIERS

2.1 General

We do not propose to analyse the advantages and disadvantages of each available project structure – that task has been performed elsewhere. However, we will briefly review the security position with respect to incorporated joint ventures and partnerships, before considering the position with respect to unincorporated joint ventures in detail.

2.2 Incorporated Joint Ventures

The so-called "incorporated joint venture" can be summarised as follows.

7 Milliner, op cit n 1, 45.

(a) A new special purpose company (SPC) is established to hold the assets and conduct the project.

(b) Shares in the SPC are owned by each "venturer" as shareholder (Shareholder), in agreed proportions.

(c) The rights of each Shareholder are governed by a combination of the constituent documents of the company, and a shareholders' agreement.

(d) Profit is determined at the SPC level. Shareholders take their return from the project in the form of dividends, other distributions (such as capital returns, share buy-backs and redemption of preference shares) and repayment of any shareholder debt.

(e) Given the nature of the rights of Shareholders, in almost all cases, any limited recourse or "project" third party debt is provided to the SPC. That is because, given the nature of project finance, third party project financiers will usually require that they rank ahead of other secured creditors and unsecured creditors. They expect to have direct recourse to the project assets (even given the potential limitations of "project security"). If third party financiers were to provide project-style debt to Shareholders without the benefit of a guarantee from the SPC of that debt, they would be reliant on the Shareholder deriving sufficient income from dividends and other distributions (as mentioned above) in order to service the third party debt. This has the obvious, and significant problem, that only profit (that is, revenue after *all* other expenses) can be distributed as dividends to shareholders and, in that sense, all the creditors of the SPC (even unsecured creditors) will rank ahead of the Shareholder (and therefore the Shareholder's financiers), in a winding up of SPC. This position is commonly known as *structural subordination*. It is possible to effect capital reductions or share buy-backs which are not dependent on profit at the SPC, but these are subject to restrictions which make them difficult to rely on. Importantly, the directors of SPC will be in breach of the *Corporations Act*, if the reduction or buy-back materially prejudices SPC's ability to pay its creditors. There are, in fact, a whole range of legal duties which impact on the ability of SPC's directors to apply SPC's assets towards repayment of the Shareholders' debt.

This form of financing, known as "Holdco financing" is sometimes used (or perhaps, it might be more correct to say, given the recent tightening of credit conditions, has *until recently* been used) within the private equity sphere.

It is not normally used for a project financing of a mining and resources project, although we are aware of a case where a minority shareholder financed part of the purchase price of its shares in an incorporated joint venture, secured against its shares and its offtake contracts. The security was coupled with a much lower than usual debt to equity ratio (one to one) and a very strong sponsor support covenant (effectively amounting to an undertaking to keep the borrower solvent). In some senses, this was therefore not a true project financing.

(f) If third party debt is provided at the SPC level, then the financing structure (at the macro level, at least) is comparatively straightforward. Security is taken over all the assets of the SPC (or as much of the assets of the SPC over which security can be taken, without the costs of taking that security outweighing the benefits).

In order to enable financiers to enforce their security by a disposal of shares (as well as a disposal of the business through a disposal of SPC's assets), security will normally also be taken over the shares in SPC. This security could either be provided by a Shareholder, or an interposed "Holdco". If direct recourse against the Shareholders is contrary to the commercial basis of the financing (that is, if the parties have sought to make the financing as limited recourse to the sponsors as possible), then it is preferable to interpose a Holdco.

It is, of course, possible to draft "limited recourse" securities but, in recent times, it has become extremely rare to see a truly non-recourse security. On the face of the security documents, security providers would normally still remain personally liable under the security documents for matters such as wilful default, gross negligence (or sometimes, mere negligence), and breach of certain "key" representations and warranties and undertakings. Care also needs to be taken that the full range of legal remedies otherwise available to financiers are effectively excluded.

If a Holdco is interposed, Shareholders will not be personally liable except to the extent that the "corporate veil" is pierced (for example, where the Shareholders act as "shadow directors" of the company[8] or under s 588V of the *Corporations Act 2001* (Cth)).

2.3 Unincorporated Joint Ventures

In commercial mining circles at least, the Australian unincorporated joint venture is well known, and commonly used in structuring multi-party transactions. Some of its features include the following:

(a) There is an association of joint venture participants in a common undertaking to generate a product to be shared between participants. The obligations in respect of that joint venture are governed by the terms of the joint venture agreement and, arguably, some of the emerging jurisprudence relating to "good faith" obligations, and obligations to act reasonably. The joint venture agreement normally contains a contractual obligation to be "just and faithful", or to act honestly or in good faith.[9] The joint venture agreement normally seeks to exclude fiduciary obligations.

(b) Each joint venture participant appoints the manager or operator (we will use the term "manager") to act as its agent. The appointment should be made severally (or separately) by each participant, rather than jointly.[10] The manager or operator is kept whole by the joint venture participants.

(c) The manager has authority to act on behalf of, and bind, the participants, by virtue of its role as agent. However, the participants have no authority to bind

[8] See eg *Standard Chartered Bank v Antico* (1995) 131 ALR 1.

[9] For a discussion of these issues in the context of Joint Ventures see Bill Dixon, "Common Law Obligations of Good Faith in Non-Fiduciary Joint Ventures" in W D Duncan (ed), *Joint Ventures Law in Australia*, (2nd ed, 2005) 81.

[10] See eg G Ryan, "Joint Venture Agreements" (1981) 4(1) *Australian Mining and Petroleum Law Journal* 101.

each other. Often, each participant will indemnify each other in respect of liabilities incurred where a participant purports to bind another participant.

(d) The manager is usually the party that enters into contracts with third parties and engages employees. Generally in entering into contracts the manager will act as the agent of the participants, but this is not invariably the case; some managers prefer to enter into contracts with third parties as principals and then to provide the goods or services themselves to the joint venture.

The liability of the participants (as principal) to third parties, for contracts entered into by the manager (as the agent of the participants), varies according to the laws of agent and principal, and the circumstances in which contracts are entered into. To ensure that the principle of several liability is given effect to (as much as possible), contracts entered into by the agent should be for disclosed principals and the contract should expressly provide for the several liability of the principals.

(e) Day to day operations are conducted by the manager. However, the manager's operations are overseen by a "management committee". The management committee will comprise one or more representatives of each participant. It will be a matter of intense debate amongst the participants which decisions require mere majority consent, and which require super-majority or unanimous consent.

(f) As a starting point, the participants in a joint venture own the "venture property" as tenants-in-common in specified shares.

A point which is often overlooked is that certain kinds of property are held by joint venturers in their own right, but can only really be used by the joint venturers in connection with the mining joint venture. Certainly, in the exploration context, there may be cases where property such as exploration and prospecting licences and intellectual property, is held only by one of the participants until certain farmin[11] milestones are met.[12]

These rights include:

(i) the choses in action representing rights under the joint venture agreement;[13] and

(ii) where the mining legislation permits creation of a "share" in a mining tenement,[14] it is arguable that the correct analysis is that the share itself is a separate piece of property held individually, rather than that the mining tenement is held as a tenant in common.

11 Farmin means the incurrence of a specified level of expenditure in connection with a joint venture which entitles the person incurring the expenditure, the "farminor", to a specified participating interest in the joint venture and a specified interest as a tenant-in-comment in the property of the joint venture, including the prospecting and exploration licences, and the intellectual property.

12 Merralls recognises this point in J Merralls, "Mining and Petroleum Joint Ventures in Australia: Some Basic Legal Concepts" (1988) 62 ALJ 907, 912-13.

13 Ladbury also recognises this point in R Ladbury "Joint Venture Financing – Lender's Requirements" (1981) Energy Law 1981 (International Bar Association Seminar Proceedings).

14 See eg the *Mining Act 1978* (WA).

There is therefore, to our minds, a separate category of property which is not owned by the joint venture participants as tenants in common, but which nonetheless can only be used in connection with the joint venture. We will refer to this, and the property that is held by each joint venture participant as a tenant-in-common, as "venture property".

The fact that each participant has a direct proprietary interest in the venture property is a key difference between the incorporated joint venture and the unincorporated joint venture, and has enabled financiers to provide funding to an individual joint venture participant, on the security of that participants' interest in the joint venture assets.[15]

In contrast with a shareholder, a financier to a participant in an unincorporated joint venture is not structurally subordinated. The financier can take direct security over a joint venturer's individual interest in the assets (whether of the venture assets as a tenant in common) or of their separate assets associated with the joint venture and therefore rank ahead of unsecured creditors, and shareholders, but to some degree behind the other joint venture participants. We discuss the extent to which financiers take their interests subject to the interests of other participants in section 3 below.

(g) Each joint venture participant has a right to *take* their share of the product. There is no concept of joint income or joint profit. Therefore, in theory at least, each joint venturer can market and sell their product separately and the business of the joint venture ends when product is taken.

In practice, these rights are often circumscribed by sales agency arrangements, particularly where product is not readily susceptible to being taken and sold entirely independently by the venturers. The practice in such cases has generally been for joint venturers to appoint a single sales agent to conduct marketing on behalf of the joint venture. The extent of the authority of the sales agent varies, from a mere marketing role (where individual participants present contracts to participants for their approval), to situations where the sales agent can bind the participants, or where the sales agent acquires product and on-sells the product to eventual customers.

The latter brings the arrangements a little closer to a partnership for tax purposes and for the purposes of the partnership legislation in Australia.

Self-evidently, the right to take a share of product is a fundamental right in any joint venture, and is fundamental to any security package in a project financing. Only after the product is taken, can there be any revenue available to the joint venture participant to meet called sums and service debt.

Notwithstanding the above, Australian law has not yet recognised the "joint venture" as a separate legal concept. There is a classic statement of the High Court to that effect:

> "The term 'joint venture' is not a technical one with a settled common law meaning. As a matter of ordinary language, it connotes an association of persons for the purposes of a particular trading, commercial, mining or other financial undertaking or endeavour with a view to mutual profit, with each

[15] See, for example, Milliner, op cit n 1, 9.

> participant usually (but not necessarily) contributing money, property or skill. Such a joint venture (or, under Scots' law, 'adventure') will often be a partnership. The term is, however, apposite to refer to a joint undertaking or activity carried out through a medium other than a partnership: such as a company, a trust, an agency or joint ownership."[16]

It is apparent from this passage that the High Court was not limiting itself to a discussion of the *unincorporated* joint venture and certainly not the unincorporated *mining* joint venture. The unincorporated resources joint venture was not in issue in that case.

Therefore, proponents of the concept of a separate Australian jurisprudence pertaining to unincorporated resources joint ventures, have a little room to move. In that same case, Dawson J stated:

> "Perhaps in this country, the important distinction between a partnership and a joint venture is, for practical purposes, the distinction between an association of persons who engage in a common undertaking for profit and an association of those who do so in order to generate a product to be shared among the participants. Enterprises of the latter kind are common enough in the exploration for and exploitation of mineral resources and the feature which is most likely to distinguish them from partnerships is the sharing of product rather than profit. *It is, however, unnecessary to pursue that matter here.*"[17] (emphasis added).

Regardless of whether there is a separate juridical concept of joint venture, however, comfort can be taken from the fact that the High Court was clearly prepared to take the first step and recognise that there *could* be an association of persons that involved agency and joint ownership but was not a partnership. Over 20 years later, and after countless joint ventures and their various disputes have been before the courts, it is difficult to conceive that there is not a role for the joint venture in Australian jurisprudence even if the courts have yet to sketch out all aspects of that role. It now seems quaint that early proponents of the mining joint venture had concerns whether an Australian court would even be prepared to recognise an association of two or more parties that was *not* a partnership.[18]

2.4 Partnership

The position with respect to a partner in an ordinary partnership is different to that of an unincorporated joint venture (for the moment, we will leave aside a consideration of a partner in an arrangement which was intended by the parties to operate as an unincorporated joint venture, but which in fact, operates as a partnership).

16 *United Dominions Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1, 10 (Mason, Brennan and Deane JJ).

17 Ibid 15-16.

18 See eg G Ryan, "Joint Venture Agreements" (1981) 4(1) *Australian Mining and Petroleum Law Journal* 101, one of the ground breaking articles to place a firm theoretical basis for the development of the joint venture in Australian law.

Let us assume for a moment that the assets of a project are owned by the partners jointly, and are used by them for the purposes of the partnership business and constitute "partnership property". This is by no means always the case, because, as Lehane notes, there may be property contributed by an individual partner or subset of partners that is not partnership property.[19]

The interest of a partner in partnership property (as such) has been famously characterised by the High Court as follows:

> "The partner's share in the partnership is not a title to specific property but a right to his proportion of the surplus after the realization of assets and the payment of debts and liabilities. However, it has always been accepted that a partner has an interest in every asset of the partnership and this interest has been universally described as a 'beneficial interest', notwithstanding its peculiar character. The assets of a partnership, individually and collectively, are described as 'partnership property' … This description acknowledges that they belong to the partnership, that is, to the members of the partnership."[20]

Furthermore, according to Mason J in *United Builders Pty Ltd v Mutual Acceptance Ltd*:

> "A mortgage or charge over a partner's share or interest in the partnership does not vest any interest in the assets of the partnership of against the other partners. What the mortgage or charge does is to confer an entitlement on the holder on dissolution of the partnership assets."[21]

As a consequence, modern practice has not been to provide finance to an individual partner on a project finance basis, on the security of the partner's partnership interest. In such a case, the lender would face a similar structural subordination problem to a lender to a shareholder in an incorporated joint venture. In a winding up of a partnership, partnership creditors (whether secured or unsecured) will be paid in priority to the partner (which is not surprising), and therefore in priority to the financier that provided funding on the security of a partner's share.

Where partnership structures are used in project financing,[22] modern practice has been for lenders to position themselves as creditors of *both* the partnership *and* the individual partners. This is done by ensuring that all partners are parties to the finance and security documentation and ensuring that obligations are assumed by the borrowers collectively as a partnership, and in their individual capacity. For good measure, individual participants are often made jointly and severally liable.

[19] Lehane J, "Current Legal Issues Relating to Lending to Trusts and Partnerships" Paper presented at the Banking Law and Practice Conference 1997, 301,309.

[20] *Canny Gabriel Castles Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 121 CLR 321, 327.

[21] (1980) 144 CLR 673, 687.

[22] For taxation and other reasons it would be rare to see sponsors of a resources project to intentionally structure the project as a partnership.

2.5 Inadvertent Characterisation of a Joint Venture as a Partnership

Since lenders frequently do lend to *individual* joint venture participants on a project finance basis on the security of their individual joint venture interest, it was thought for a long time critical that a financier be satisfied that the arrangements comprised a joint venture and not a partnership, so as to avoid structural subordination. In some respects, this was particularly courageous as it was, for many years, by no means certain that a court would recognise the mining joint venture as something other than a partnership.[23]

However, recent thinking has been that this matter is, in fact, less critical than previously thought.

The first reason for this change in thought is, that we think, since *United Dominions Corporation Ltd v Brian Pty Ltd*, it is at least clear that the High Court is prepared to recognise that there can be an association of persons that is not a partnership.

The second strand of reasoning relates to the ability of partners to designate what constitutes partnership property and what is merely property of each individual partner which is used in connection with the partnership but which is not a partnership asset. After reviewing the provisions of the various partnership statutes in Australia, Lehane concludes that "the agreement between partners as to the way property is to be owned is all important."[24] In a typical joint venture agreement, it is generally clear that the parties intend the joint venture property to be retained by the venturers and this is reinforced by the provisions which authorise the individual venturer to charge its participating interest.

Therefore, we would argue that as long as the "joint venture" agreement provides that property used for the purposes of the "joint venture" is owned by the parties as tenants-in-common in specified proportions, and the agreement makes it clear that a party could grant security over its individual interest in favour of a financier, then the financiers should not become structurally subordinated, as a consequence of the joint venture relationship, or some part of it, constituting a partnership.

Even if a court were to hold that the participating interests of joint venturers formed part of the partnership property there may still be another argument. This is to the effect that if the partnership authorises a partner to grant a mortgage over partnership assets (in this instance, the assets the subject of the venturer's participating interest would be held by the joint venturer on behalf of the partnership) to secure the partner's individual debts then, subject to the partnership being solvent at the time of giving the mortgage,[25] there seems no

[23] See eg G Ryan, "Joint Venture Agreements" (1981) 4(1) *Australian Mining and Petroleum Law Journal* 101.

[24] Lehane J, "Current Legal Issues Relating to Lending to Trusts and Partnerships" Paper presented at the Banking Law and Practice Conference 1997, 301,309.

[25] This would be a duty on the partners analogous to that of directors of a company when the company is insolvent or near insolvent (see *Walker v Wimborne* (1976) 137 CLR 1) to avoid actions which are not in the interests of creditors of the company.

reason of principle or policy[26] why the security ought not to be effective. The authority from the partnership could arise either through the joint venture agreement itself or the deed of covenant which is conventionally entered into when a joint venturer charges its participating interest.

To summarise, we consider that an appropriately drawn minerals joint venture should not be at risk of recharacterisation as a partnership. Further, if this were to occur, there are good reasons to think that a security given by a joint venturer over its "participating interest" would still be effective in accordance with its terms.

However, because the position is still not beyond doubt, and for the reasons set out below, it is probably still prudent for a financier to want to ensure that the arrangement did not constitute a partnership.

(a) Joint liability of partners

Each partner is jointly liable for liabilities incurred by each other partner in the course of the partnership business or with the authority of the partners. By contrast, in a properly drawn joint venture, liability should be several.[27]

Suppose A and B have entered into an arrangement which they thought was a joint venture, but which was, in fact, a partnership. Their respective interests are 60% for A and 40% for B. Suppose also that A is the operator of the joint venture.

If A incurred a liability in its ordinary course of business to a third party, T, of $100 and the arrangements comprised a partnership, T could sue B for the full $100. T might do this if B had, as compared to A, the proverbial deeper pocket. On the other hand, if the arrangements comprised a joint venture, then the liability of B will depend on the application of the laws of principal and agent. B may be severally liable to T, or not liable at all if A did not disclose that he was acting as agent for B. It is open for A and B to structure their arrangements with T such that B would only be liable for the $40. If the contract with T made it clear that A and B were only severally liable as principals, then it would obviously be difficult for a court to look past that arrangement and impose joint liability.[28]

Even if the arrangements did constitute a partnership, it is not a *catastrophic* result from the perspective of the financiers because, assuming T is an unsecured creditor, if B were insolvent, or made insolvent by the claim, B's financiers should rank ahead of T as an unsecured creditor. Under a properly drawn joint venture, B (or B's financiers) should also be able to sue A to recover from A the $60 for which A should have been liable.

However, it could still be a comparatively *unpleasant* result for a number of reasons.

[26] The law has always subordinated the non-partnership creditors of a partner to the partnership creditors in relation to partnership assets but we are not aware of any principle or policy which prevents a partnership from giving a security on behalf of the debts of an individual partner.

[27] See eg R Ladbury, "Mining Joint Ventures" (1984) 12 ABLR 312.

[28] J Merralls, "Mining and Petroleum Joint Ventures in Australia: Some Basic Legal Concepts" (1988) 62 ALJ 907, 918.

In the pre-insolvency world, T's claim still needs to be met. Financiers would have assumed a particular cash flow and liability profile in assessing the merits of the financing. From such a standpoint, joint liability imposes a drain on cash flows until any contribution from the co-participant is recovered, if indeed it is recovered. Until such time, less cash is available to meet other operating costs, and therefore the ability to service debt whether in the present, or in future periods. This could have an impact on financial covenants.

The partnership/joint venture dichotomy (or the partnership/non-partnership dichotomy) also arises in the context of tort, particularly where the proportionate liability legislation applies, for example, in the case of negligent damage to property in Victoria.[29]

Let us assume the facts above, but that the liability incurred to T was tortious and that the proportionate liability legislation applied to the situation. Let us also assume that T sued both A and B. If A and B were not partners, and A was a concurrent wrongdoer for the purposes of the proportionate liability legislation, B's liability would be limited to the proportion of the loss that it caused to T.[30]

However, the proportionate liability legislation in Victoria does not prevent a partner from being held jointly liable with another partner for that proportion of an apportionable claim for which the other partner is liable.[31]

(b) Fiduciary obligations

Another consequence of characterisation as a partnership is the imposition of fiduciary obligations on each of the partners vis-à-vis each other. In a joint venture relationship, joint venturers do not normally owe each other fiduciary obligations, unless special circumstances arise, or the joint venture agreement so provides.[32] A well drawn joint venture agreement should specifically exclude the incidents of a fiduciary relationship that may arise (such as an obligation to take account of another's interests, or account for profit), as well as deny that a fiduciary relationship exists between the participants. It is therefore likely that at least some of these exclusionary elements will be present in any agreement purporting to be a joint venture.

[29] See eg s 24AF(a) of the *Wrongs Act 1958* (Vic).

[30] See eg s 24AI of the *Wrongs Act 1958* (Vic).

[31] See eg s 24AP(c) of the *Wrongs Act 1958* (Vic).

[32] Over the years, there have been many papers analysing whether joint venturers owe each other fiduciary obligations: see eg P D Finn, "Fiduciary Obligations of Operators and Co-Venturers in Natural Resources Joint Ventures" [1984] AMPLA Yearbook 160; M Cope, *Equitable Obligations – Duties, Defences and Remedies* (2007) (especially Ch 3); M Crommelin, "The Mineral and Petroleum Joint Venture in Australia" (1986) 4 *Journal of Energy and Natural Resources Law* 65; R Ladbury, "Mining Joint Ventures" (1984) 12 ABLR 312, 323-329.

3. PRIOR RIGHTS OF OTHER PARTICIPANTS UNDER A JOINT VENTURE

3.1 General Position

As noted above, a financier to a participant in an unincorporated joint venture is not *structurally* subordinated.

The financier can take direct security over a joint venturer's individual interest in the assets (whether of the venture assets as a tenant in common) or of their separate assets associated with the joint venture; and therefore rank ahead of unsecured creditors, and shareholders of the participant.

However, the financier's security interest in a participant's interest in a joint venture will be subject to, and subordinated to, the interests of the other joint ventures, at least to some degree.

In commercial practice, it is accepted, in a general sense, and subject to certain limitations that the cross charge constitutes a prior ranking interest of the other participants (see paragraph 3.2 below).

The more interesting issue from a legal perspective is whether the other joint venture participants have any other type of interest in the venture property, to which the financiers must be subject. This is examined in sections 3.3 to 3.5 below.

3.2 Cross Charge

Most joint ventures, at least in the development phase of the joint venture, use a cross charge mechanism.

Under a cross charge, a joint venture participant will grant a fixed and floating charge, or merely a floating charge, over its individual interest in the joint venture, its product, its interest in insurances. It will also often grant a cross charge over its sales contracts and sometimes, their proceeds. The cross charge will be granted in favour of the other participants and, sometimes, the manager. A joint venture participant may also grant a registrable mining mortgage under the relevant mining legislation, in respect of its mining tenements. For the sake of convenience, we will use the term "cross charge", to describe both.

The purpose of the cross charge is to secure payment of various amounts in favour of the manager and the other participants. Such amounts include:

(a) called sums payable in favour of the manager, in relation to operating costs;
(b) called sums payable in favour of the manager, in relation to non-discretionary capital costs;
(c) potentially, discretionary capital expenditure incurred for the purpose of expansions;
(d) contributions made by non-defaulting venturers on behalf of defaulting venturers (whether or not they relate to the above); and

(e) potentially, other amounts.

In Australia, financiers have generally accepted the market position that the cross charge ranks ahead of the financier's security interest, at least insofar as it secures called sums incurred in connection with called sums relating to operating costs, non-discretionary capital expenditure and contributions made on behalf of defaulting participants (to the extent they relate to those things).

In fact, financiers in Australia have sometimes accepted that all liabilities owed by joint venturers to each other or the manager and secured by a cross charge will rank ahead of the financiers' security interest. This is perhaps due more to necessity than design (for example, because the financier is financing the acquisition of an interest in a pre-existing joint venture, or because the financiers did not become involved in the negotiating process until comparatively late in the piece).

3.3 The Negative Stipulation

It is interesting to consider whether joint venturers should be regarded as having some form of proprietary interest in the participating interest of each other participant, entitling the first-mentioned joint venturer to require that venture property be used solely for the purposes of the joint venture activities.

It is axiomatic that all the initial joint venturers will, initially at least, wish to ensure that all joint venturers use their respective venture property for the purposes of the joint venture. However, under State property law statutes, owners of real property or goods who are tenants in common, can apply to the relevant court for partition of the property so held. The court could order for sale of the co-owned property, or a physical division of the property.[33]

For that reason, joint venture agreements should contain a covenant not to seek partition,[34] and a covenant to use joint venture property for the purposes of the joint venture.

If financiers exercise a power of sale under their security in respect of the joint venture interest, will any purchaser be compelled, inter alia, not to seek partition and to use that joint venture interest for the purposes of the joint venture?

At a practical level, the joint venture agreement and any direct agreement (or consent deed or joint venture deed of covenant) with the financiers should govern these matters. Further, the other joint venturers should have appropriate rights against the transferor and financier in the event that the incoming purchaser fails to properly assume the obligations of a joint venturer under the joint venture agreement. The cross charge may also have a role to play in preventing this situation from occurring.

[33] See eg *Property Law Act 1958* (Vic), ss 225-233.
[34] Milliner, op cit n 1, 29.

As such, the question of the need for recognition of a proprietary interest should rarely arise. It has not, to our knowledge, been tested by the courts. However, the possibility has been left open by commentators. Merralls suggests:

> "The mutual agreements of participants to commit assets to the venture and not to seek partition create personal obligations enforceable between the parties, but it is a moot point whether they confer legal or equitable interests in the assets apart from the proprietary interests arising from the agreement that assets used in the venture are to be owned in common."[35]

Mr Justice Lehane, writing extra-judicially, has said:

> "It is possible that the terms of the agreement will, whether or not the venture is to be regarded as in law a partnership, give rise in each venturer to an equitable interest in the separately owned shares of the others."[36]

The case of *MI Design Pty Ltd v Dunecar Pty Ltd,*[37] lends some support to these propositions. It concerned a consent deed under which the mortgagee of a lessee's leasehold interest had a right to cure the default of the lessee vis-à-vis the lessor. The lessor was not entitled to exercise his rights for breach of the terms of the lease by the lessee, until such time as notice was given to the mortgagee, and the mortgagee had an opportunity to rectify the breach.

The court determined that the mortgagee was entitled to an order of specific performance of the consent deed. According to Santow J:

> "The parties clearly recognise that unless the Bank is given an opportunity to rectify a breach or pay reasonable compensation otherwise for the lessor's damages where reasonably quantifiable, the Bank is at risk of losing the whole benefit of its security. Damage in those circumstances would not be an adequate remedy because the value of that which had been thereby forfeited would be not only difficult of ascertainment but would deny the Bank the opportunity either to leave the existing tenant in occupation or exercise power of sale, doing so moreover in a situation where the Bank has incomplete knowledge about which option would best suit its commercial interests. *Equity would expect the lessor to abide by the negative covenant, not attempt to buy its way out by breaching and then claiming damages would be an adequate remedy.*" (emphasis added)[38]

This passage is authority for the proposition that, in appropriate cases, the court would grant specific performance of a negative covenant, so as to preserve the bargain between the parties.

There is certainly a parallel between the negative covenant in the consent deed in *MI Designs* and the kinds of negative covenants that are often seen in the joint venture context. How could the loss of use of property for the purposes of a joint

35 J Merralls, "Mining and Petroleum Joint Ventures in Australia: Some Basic Legal Concepts" (1988) 62 ALJ 907, 912-913.

36 Lehane J, "Current Legal Issues Relating to Lending to Trusts and Partnerships" Paper presented at the Banking Law and Practice Conference 1997, 301, 310.

37 [2000] NSWSC 996.

38 Ibid, [76].

venture project be ascertained? Looking from say, 1990, how could someone have adequately quantified the value of an iron ore joint venture interest in the Pilbara in 2007?

This does not mean that the law is yet at a point at which a joint venturer can be regarded as having an equitable interest in another joint venturer's property, by virtue of the mere existence of a negative stipulation capable of being specifically enforced. In fact in *Redglove Projects Pty Ltd v Ngunnawal Local Aboriginal Land Council,*[39] White J stated:

> "There have been numerous instances where the courts have held that no equitable estate or interest in land is created by an express or implied promise not to deal with the land except in conformity with a contract. The fact that equity will enforce the negative promise by injunction does not transmute a purely personal claim into a proprietary interest."[40]

However, suppose that the third party took the transferor's interest in the joint venture assets *without* a contractual assumption of the obligations under the joint venture agreement. For dramatic effect, let us also assume that the third party then sought partition of the property held as tenant in common.

It may not be enough for the joint venturers to have a right of action for damages against the transferor or the financier.[41] If no financier is involved, the position would be exacerbated, if the transferor were insolvent, as the right of damages against the transferor would be of little or no use.

In such a case, the principles of *Latec Investments Ltd v Hotel Terrigal Pty Ltd*[42] might be extended somewhat, so that the other joint venturers could have an equity to set aside the transaction between the person bound by the joint venture obligations (whether that be the transferor or the financier) and the acquirer of the interest in the joint venture property; so that the joint venture property could be re-conveyed on terms subject to the joint venture agreement. It is recognised that this is straining the existing law a little, but it is difficult to see how justice might otherwise be done.

Another alternative might be for a court to strain to find a way to ensure that the transferee assumed, or acquiesced in assuming, the obligations imposed by the joint venture agreement. This would probably represent a practical (albeit imperfect) way of ensuring that joint venture obligations were assumed. The existence of the cross charge could help to support this argument.

The alternative position (advocated by many commentators,[43] although not yet law in Australia) is to start from the proposition that the interest of a joint venturer in the assets of a joint venture should be regarded as a sui generis form of property

39 [2004] NSWSC 880.
40 Ibid [26].
41 Again, see *MI Design Pty Ltd* v *Dunecar Pty Ltd* [2000] NSWSC 996.
42 (1965) 113 CLR 265.
43 J Merralls, "Mining and Petroleum Joint Ventures in Australia: Some Basic Legal Concepts" (1988) 62 ALJ 907; M Cromelin, "The Mineral and Petroleum Joint Venture in Australia" (1986) 4 *Journal of Energy and Natural Resources Law* 65.

interest (in the same way that an interest of a partner in a partnership has been recognised as a separate form of property interest). We would suggest that many of the conceptual difficulties would be solved, if it were recognised as a principle of law that all of the property designated by the participants as “joint venture property” was subject to a form of equitable chose in action in favour of the participants, to the effect that the property could only be used for the common purpose of the joint venture.

Absent this, the best position for joint venturers is to ensure that the transfer mechanism in the joint venture agreement and consent deed, and the cross charge, is as water tight as possible. This is also of critical importance to financiers to joint venturers. It would be a catastrophic situation if a financier to one participant, A, were at risk of B, or B’s financier, transferring B’s interest to T, in circumstances where T could call for partition of the joint venture property or seek to use the joint venture property otherwise than for the purposes of the joint venture. Recall that in most cases in a project financing, the financier’s interests are best served if the project were operating and producing sufficient product to service debt.

3.4 Right to Take Production of Another Participant

It is sometimes said that the joint venture (that is the relationship with the participants) ends with the production of minerals because, at that point, each joint venturer owns the product individually, and each is free to separately dispose of its product, subject to any other relationship between the parties. However, this is not strictly so, in either a physical or legal sense.

In a physical sense, certain types of product are not likely to be separately stockpiled at that point. In fact, unless the joint venturers have entered into different sales contracts, it does not make economic sense to stockpile such product separately at all. That is because the physical act of segregation costs money; and the need to keep product separately will result in a reduction in the amount of product that can be transported (due to the need to keep the product separate) and stockpiled (due to the need for a number of separate stockpiles, rather than one large stockpile). This results in a reduction of the amount of product that can be passed through the infrastructure system in any given period, and therefore a reduction in the amount that can be sold.

In a legal sense, many joint venture agreements provide for a loss of the right for a participant to take its share of production, or a reduction in that share, following the occurrence of a default, either permanently, or during that default. Insofar as these rights extend to product already produced, it can be seen that the relationship between the parties extends beyond the point of production.

It is first necessary to consider whether the right to take a specified share of production is contractual or proprietary.

From the point in time at which product is extracted, until the point in time at which it is sold, the defaulting participant will normally own the product. The mining statutes are not always clear on the precise point at which ownership to product is obtained,[44] but the general proposition must be that once extracted, the product is owned by the tenement holders. Thus, immediately once the product is extracted, it is owned by the participants as tenants in common in proportion to their ownership interests in the mining tenement. In turn, the ownership interests in the mining tenement are determined, initially, by the participants' initial joint venture participating interests, and then subject to change as the participating interests change in accordance with the terms of the joint venture agreement.

It is then necessary to consider the nature of the right of the non-defaulting participants and/or the manager to take product owned by a defaulting participant.

Depending on how the right to take is drafted, it could be characterised as merely a contractual right (which would normally be secured by the cross charge), or a security interest in its own right (that is, separate to the cross charge). If there is a risk that the right to take might constitute a security interest, it should be included in a registered document (normally, the cross charge itself). In such cases, the right to take is essentially dependent on the enforceability of the cross charge. This becomes an issue if the cross charge is not designed to be "administrator proof".

Rights to take are not normally drafted in a way which would confer title to the product from the outset. It is probably possible to do so, and this may be beneficial to the non-defaulting participants (particularly in an administration); but it would probably involve too fundamental a change to the parties' rights for this to be countenanced. In any event, the best protection is to make the cross charge administrator proof.

3.4.1 Contractual right to take secured by a cross charge

According to Professor Goode:

> "The assignment of a debt or transfer of another asset in reduction or discharge of the assignor's own indebtedness to the assignee does not constitute a security interest but an outright transfer. The principle was long ago applied in Ex p. Newitt, in Re Garrud [(1881) 16 Ch.D 522], where a provision in a building contract entitling the building owner, upon default by the builder, to take the builder's materials towards discharge of the builder's liability for damages was held not to create a security interest, for the materials were taken not as security for the builder's obligation but towards discharge of it."[45]

A mere contractual right to take is nonetheless very useful in the pre-insolvency world. It involves the defaulting participant giving the manager an authority to deal with the product in a particular way. As the manager has physical control of that product, it is very difficult for the defaulting participant to do anything about the manager's exercise of its authority.

[44] See eg J Tarrant, "Ownership of Mining Product, Tailings and Minerals" (2005) 24(3) *Australian Resources and Energy Law Journal* 321.

[45] R M Goode, *Legal Problems of Credit and Security* (3rd ed, 2003) 25.

However, absent anything else, a mere contractual right to take would not survive the insolvency of the defaulting participant. A liquidator of the insolvent participant could decide not to perform the right and leave the other participants with a remedy in damages.

In *Goldcorp Exchange Ltd & Ors v Liggett & Ors,*[46] the plaintiffs sought to establish a proprietary right in gold bullion held by an insolvent company. The Privy Council decided that most of the claimants did not have a proprietary right to any specific gold bullion. The consequence of this was quite dramatic. Those claimants were entitled only to damages for failure to deliver gold bullion; and were required to prove as unsecured creditors for those damages. A subset of claimants had, for various reasons, a proprietary interest in certain of the gold bullion. This entitled them to recover a quantity of gold bullion which, in turn, significantly reduced the pool of assets available to unsecured creditors.

Further, if the insolvent participant did in fact perform the contractual obligation, any transactions that occurred whilst the company was insolvent, or in the relevant period prior to insolvency, would be capable of being set aside as a preference.

However, in joint venture scenarios, it is often the case that the contractual right to take is secured by the cross charge. This will be the case if the cross charge secures performance of the relevant obligation, as opposed to the mere payment of money.

The utility of this situation depends on the ability of the non-defaulting participant/cross chargee to enforce the cross charge. There are two potential issues.

(a) Administration
If an administrator is appointed to the defaulting participant, and the cross charge is not in respect of all, or substantially all of the property of the defaulting participant, the cross charge will not be enforceable during an administration.[47] Furthermore, the administrator is not prevented from disposing of product in the ordinary course of business, even if it is subject to a charge.[48] The administrator is not likely to be held liable in its own right for breach of the joint venture agreement if this occurs,[49] although the defaulting participant will be liable for damages for breach of contract, because the administrator would have committed the relevant breach as agent for the defaulting participant.[50] Depending on the nature of the secured liabilities under the cross charge, the claim for damages could also be secured. However, the utility of this to the non-defaulting participant will vary according to the priority regime agreed with financiers. If the cross chargees only have priority

[46] [1995] 1 AC 74.
[47] *Corporations Act 2001* (Cth), s 440B.
[48] *Corporations Act 2001* (Cth), s 442C.
[49] *Corporations Act 2001* (Cth), s 443C; *Molit (No 55) Pty Ltd v Lam Soon Australia Pty Ltd (No 2)*(1996) 68 FCR 319.
[50] *Corporations Act 2001* (Cth), s 437B.

with respect to called sums (as was traditionally the case), the claim for damages will rank behind the financiers' claims.

(b) Clogging

The issue of clogging arises because the product is subject to a cross charge, but there is also a right to take product and apply it towards discharge of a liability (and thereby prevent release of the product from the cross charge). We will discuss the issue of clogging in more detail in section 6.2.

In our view, on the current state of the authorities, the doctrine of clogging should not prevent the right to take and the cross charge being given effect.

3.4.2 Specific title to product

Given the above, should the right to take product be drafted so as to confer on the non-defaulting participant, or the manager, title in the product of the defaulting participants?

In *Goldcorp*, the Privy Council indicated its reluctance to find any legal or equitable interest in the gold bullion by virtue simply of a contract of sale and payment of the purchase price. Therefore, in order to establish a claim of title, something more is needed. For example, in *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd (in liq) and Anor,*[51] the High Court gave effect to a trust arrangement, under which the relevant property was subject to a trust. Proceeds from the sale of property were distributed to Party A, but became distributable to Party B on the occurrence of a specified event. It may well be that such a trust arrangement could be drafted in the joint venture context, that is, product and its proceeds are subject to a trust in favour of all the participants, but the proceeds become payable to the non-defaulting participants on a default.

There could be some benefits in taking this approach in an administration. If the joint venture agreement provides for a liquidated sum being payable for taking of product by the defaulting participant in breach of this provision, it is submitted that the administrator could be liable for debts incurred for "goods bought" or "property used".[52] The benefit of this approach would be to influence the behaviour of an administrator during the period of an administration.

However, in our experience, this approach has not yet been taken. As mentioned earlier, it probably involves too great a change to the nature of the parties' rights. In any event, the approach would not need to be taken in cases where the cross charge is administrator proof.

Generally speaking, there should not be any difference between a cross charge and specific title in a liquidation. In either case, absent any arrangements made with the liquidator, the product is removed from the fund available to unsecured creditors.

[51] (2000) 202 CLR 588.

[52] *Corporations Act 2001* (Cth) ss 443A and 443B.

3.4.3 Separate security interest

Alternatively, the right to take production could constitute a security interest, separate to that created by the cross charge.

In *Re Cosslett (Contractors) Ltd,*[53] Millett LJ said:

> "It is the essence of a charge that a particular asset or class of assets is appropriated to the satisfaction of a debt or other obligation of the chargor or a third party, so that the chargee is entitled to look to the asset and its proceeds for the discharge of the liability."[54]

A right to take, coupled with a power of sale, contains many of the indicia of a registrable charge.[55] The fact that the power of sale is not included in the joint venture agreement as a default remedy (it merely follows from the right to take the product) may be a relevant factor, but it is difficult to express a concluded view that this distinguishes the remedy from a security. It is also relevant to consider whether the right to take production only extends to a right to take an amount necessary to satisfy the liability (or some greater or lesser amount), and whether the non-defaulting participant is obliged to account for the excess to the defaulting participant.[56] The High Court said in *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd (in liq) and Anor* that: "Equity favours the identification and protection of an equity of redemption and, in that regard, prefers substance to form."[57]

So far as we are aware, the proposition that a loss of rights of production clause does not constitute a registrable security interest, has not been tested by the courts. It will in any event, depend on the particular form of words used.

If it turns out that the loss of rights of production clause does, in fact, create a security interest registrable under s 262 of the *Corporations Act 2001* (Cth) and there is a failure to register, the consequences will be quite dramatic. It will mean that the loss of rights of production clause is void as against a liquidator, administrator or deed administrator. For that reason, prudence dictates that the clause should be contained within a registered instrument. In order to avoid registering the joint venture agreement (and therefore making the document public), the relevant clauses should be included in the cross charge. The participants would expect to have to register the cross charge in any event; and therefore they are not likely to have included any confidential information in the cross charge.

3.4.4 Manager's lien

A related form of remedy is the so-called "manager's lien" or "operator's lien". In a strict legal sense, a lien is a right of a person having possession of the property

53 [1997] 4 All ER 115.

54 Ibid 125.

55 *Re Cosslett (Contractors) Ltd* [1997] 4 All ER 115.

56 *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd (in liq) and Anor* (2000) 202 CLR 588, 607.

57 Ibid.

of another person, to withhold delivery of that property to that other person, until that other person discharges performance of its obligation.[58] The manager's lien is not strictly a lien. It is similar to the remedy for loss of right of production, except that the person having the right to apply production toward satisfaction of a liability is the manager, and, at least for a certain period of time, the manager has possession of the production. The element of possession may give the manager's lien some of the indicia of a pledge.

The so-called manager's lien is often used as a way of keeping the manager whole in cases where a non-defaulting joint venturer is not obliged to make good the default of another joint venturer. Many of the issues associated with loss of rights to production discussed in section 3.4.3, apply to manager's liens. That is, there are good arguments that the lien constitutes a registrable security interest, and should be contained within a registrable security document. The manager's lien will be similarly affected by issues associated with administration. For that reason, in our view, the manager is best served if the manager is a cross chargee under an "administrator proof" cross charge.

Curiously, it seems that some of the problems associated with administration do not apply to the extent that the manager's lien constitutes a pledge or lien, but not a charge[59] (on the basis that the relevant sections of Pt 5.3A only apply to charges, and the administrator therefore has no right to recover possession of pledged goods). However, the existence of the pledge or lien depends on the factual element of possession. It is submitted that there are sufficient uncertainties associated with establishing the factual element of possession in such cases, not to justify reliance on this principle. For example, at the time the manager's lien is relied upon, the property in the possession of the manager will not be the product in its possession at the time the pledge document is entered into (that is, the so-called lien will apply to *future* production not at that time in the possession of the manager). If the lien constitutes any form of security, there is therefore at least a material risk that it constitutes a floating charge. Alternatively, if it is a pledge, it is likely to cause preference concerns, as the element of possession relied upon to create the security will not occur until the product is extracted (and this could occur after the relevant liability has arisen, and the participant is deep in insolvency).

3.4.5 Future production

The analysis in respect of a loss of, or a reduction in the right to take, *future* production may be a little different to the analysis above. This will be the case if the loss or reduction occurs as a consequence of a loss or reduction in the underlying participating interest and mining tenement, or share in mining tenement. If that is the case, there is no need to consider the nature of the right to take production. The non-defaulting participant will own the relevant product from the point in time at which it is extracted.

58 See eg *Re Cosslett (Contractors) Ltd* [1997] 4 All ER 115.

59 See *Osborne Computer Corp Pty Ltd (vol admin apptd) v Airroad Distribution Pty Ltd* (1995) 17 ACSR 614.

3.4.6 Relevance to financiers

The analysis in much of this section has primarily been from the point of view of ensuring that the non-defaulting participant protects its rights against the defaulting participant (which is therefore to the detriment of the financier to the defaulting participant). However, financiers generally should be interested in knowing that the loss of rights of production clauses are effective. That is because, a financier to A would be interested to know that if A made a joint venture contribution on behalf of B (if B were in default), that A had an effective entitlement to B's share of production, to the extent of such contribution.

3.5 Forfeiture or Abatement of Other Property Interests

Many joint venture agreements also provide for a forfeiture or abatement of joint venture interests following an event of default.

"Forfeiture" means a loss of the joint venture interest in its entirety. Forfeiture clauses cause obvious problems for financiers. Over the years, there has been much debate about whether forfeiture clauses were enforceable, or subject to the equitable doctrine of relief against forfeiture. From a financiers' perspective, it would not be prudent to rely on the doctrine of relief against forfeiture. In any project financing scenario where all parties were relatively sophisticated, and have obtained reasonable legal advice, it is likely to be difficult to establish that there is much room for the doctrine to operate.[60]

"Abatement" means a reduction or abatement of joint venture interests. This may include a loss of rights to production, or production may be treated separately.

In many respects, the analysis in respect of forfeiture and abatement clauses is similar to our analysis of the right to take production in section 3.4. In particular, an issue arises as to the proprietary or contractual nature of the right to effect a forfeiture or abatement; and whether any contractual right is secured by the cross charge.

In the case of present property, particular issues arise where some substantive step is required to perfect the dealing in property.

For example, in some cases, it may not be possible to transfer the mining tenement, or interest in the mining tenement, without the agreement of the Minister or mining registrar under the relevant mining legislation[61] or under an applicable state agreement.[62] In such a case, it is difficult to see how an equitable interest could be found, until the consent is given.[63] This is because it is difficult to see how a court could

[60] See P Doyle, "Project Finance: Issues for Project Sponsors and Project Contract Counterparties" [2003] *AMPLA Yearbook* 84, 106-107; P Cornwell, "Project Finance" Paper presented at 18th Banking Law Conference, 11-14.

[61] See eg s 121 of the *Mining Act 1992* (NSW) and s 96 of the *Mineral Resources Act 1989* (Qld).

[62] See eg *Iron Ore (Hamersley Range) Agreement Act 1963* (WA).

[63] See D Maloney, "Recent Changes to the Petroleum (Submerged Lands) Act Regarding Dealings and Transfers" [1986] AMPLA Yearbook 300, 306-07; cf A Gardner and M Jorek, "Dealings with Mining Titles under the Mining Act 1978 (WA): Part 1 – Requirements of Form, Consent and Registration" (2005) 24 ARELJ 342, 358-59.

order specific performance, absent that consent being obtained. Nonetheless, the joint venture agreement should contain covenants to take all reasonable steps to obtain that consent, and such covenants ought to be capable of being specifically enforced.

Some steps may be less substantive, and therefore may not preclude the immediate recognition of an equitable interest. For example, reg 75(g) of the *Mining Regulations 1981* (WA) provides:

> "when –
> (i) a mining tenement is encumbered by a mortgage; or
> (ii) a share in a mining tenement is encumbered by a mortgage and the transfer affects that share,
>
> the transfer shall be accompanied by the written consent of the affected mortgagee."

Thus, the transfer is subject to the financier of the defaulting joint venturer providing its written consent. This goes some way towards reversing the normal position that a financier takes its interest subject to the abatement rights of other participants. However, in our experience, this reversal is itself normally undone, by providing in the joint venture deed of covenant or deed of priority that a financier is obliged to give its consent to a transfer of a share in a mining tenement if it occurs in accordance with a dilution.

Once again, it should be pointed out that this provision is also of interest to the financiers to the non-defaulting joint venturers. If the non-defaulting joint venturer has contributed additional expenditure beyond their required share, they would not get the benefit of an increased share of the tenement or other part of the participating interest, unless the financier to the defaulting joint venturer consented to the transfer.

4. DIFFERENT TYPES OF VENTURE PROPERTY

4.1 Overview of Section

In section 3, we described the position of a financier vis-à-vis the other participants in respect of interests in the venture property in general. In this section, we will consider some specific forms of venture property, and the issues associated with taking security in respect of it. As Milliner said: "The lender's advisors will have to examine the nature of the interests the subject of the securities and advise the lenders as to the most effective form of security to be taken."[64]

4.2 Mining Tenements

In Australia, subject to a few exceptions, sub-surface minerals are owned by the Crown in right of each State.[65] As the Crown is generally the owner of the mineral,

[64] Milliner, op cit n 1, 56.
[65] The Crown in right of the Commonwealth is the owner of petroleum and gas in Australian territorial waters outside of the State's territorial waters.

it may grant various forms of concessions to persons granting those persons the right to undertake various activities as part of the mining process.

The nature of the activities that can be undertaken will vary according to the form of concession granted: for example, at the preliminary stage, there may be a right to explore within a narrower area and at a later stage, there may be a right to extract the mineral resource in commercial quantities, and build associated infrastructure on the tenement.

Third party finance is normally only obtained when it is foreseeable that revenue will be earned from the project. This is normally only the case when a mining tenement has been issued and construction of the mine, and related infrastructure, is imminent. Hence, third party financiers are not likely to be involved in the process any earlier than when mining tenements are involved. We will therefore focus on the nature of the mining tenement.

It is important to recognise that a mining tenement does not confer title to subsurface minerals on a tenement holder. It only confers a *statutory right to extract* minerals from the surface. That right is proprietary in nature and, subject to certain limitations, it can be assigned or encumbered.

The legislation is not perfect, and varies between the States. It is accordingly necessary to undertake a rigorous analysis of the legislation in each State, to determine whether the legislation is capable of reflecting the joint venturers' intentions and, if not, how the joint venture agreement needs to be modified. For example:

(a) In Queensland, a mortgage of a mining tenement will not be effective unless the mining registrar has approved the mortgage.[66] This is obviously something financiers will need to take into account in planning the transaction. Under the Act, the mining registrar has up to three months to give its approval. Similarly, an assignment of a tenement or interest in a tenement can only be made with the consent of the mining registrar. Therefore, in order to give effect to abatement provisions, the mining registrar's consent is required.

(b) The *Mining Act 1978* (WA) recognises the concepts of *shares* in tenements. Thus a 40% participant in a joint venture could be granted, to take an extreme example, 2/5 shares of a tenement, and so forth. However, the *Mining Act 1978* (WA) does not permit fractions of shares. Accordingly, if a participants' interest is abated by an amount which is smaller than the smallest fractional share contemplated for that mining tenement, the mining tenements held by each participant will not reflect the parties' intentions with respect to the parties' shares in the joint venture. The simplest solution would be state that the tenement is divided into some large number of shares, say 1000, or even 10,000. Alternatively, in Western Australia, it should be possible to rely on express trust arrangements to confer equitable interests.[67]

[66] *Mineral Resources Act 1989* (Qld), s 96.

[67] A Gardner and M Jorek, "Dealings with Mining Titles under the Mining Act 1978 (WA): Part 1 –Requirements of Form, Consent and Registration" (2005) 24 ARELJ 342.

4.2.1 The right of extraction

Another issue for financiers arises from the nature of the participants' interest (or lack thereof) in subsurface materials.

If an adjacent tenement holder, constructed its mining operations in a way which resulted in extraction of minerals from the tenement in question, it is suggested in *Halsbury's Laws of Australia* that a tenement holder would have no recourse against the adjacent tenement holder.[68]

> "The question of ownership of minerals has also arisen in cases relating to unlawful mining. Where a person mines on another's tenement without consent, that person is not entitled to the proceeds. However, the tenement holder is not entitled to them either because ownership of minerals only passes to a tenement holder when the minerals are mined. Nor is the tenement holder entitled to damages because of the unlawful mining."

If this is the case, financiers should be particularly wary of "sole risk" or "joining participant" clauses. These are clauses which enable a sole risk participant to undertake a mine expansion by themselves, or with only a subset of the other joint venturers.

Even if the sole risk participants obtain a separate mining tenement (which they should, given ownership of the tenement will be different to that for the main joint venture), it will be necessary to determine whether any of the sole risk operations result in any of the subsurface minerals being taken from the main operations. If the position postulated by Halsbury's is correct, then the non-sole risk operators will have no recourse against the sole risk operators. This is obviously an issue for financiers, as there could be an impact on the rate of extraction and the quality of product extracted, without any recourse. Obviously, this could impact on the physical financial covenants described in section 1.4(d) above. More seriously, it could impact on the eventual ability of the ore body to generate sufficient cash to service debt.

There are a number of ways in which a financier could get comfortable with sole risk provisions, short of deleting them. For example, many joint venture agreements contain a covenant not to interfere with the main joint venture operations and an indemnity from the sole risk participants for loss caused by those operations. However, to properly cover off against the risk identified by Halsbury's, there should be an indemnity for any damage to the sub surface minerals underneath the joint venture tenement. The indemnity should cover loss of profits from sales. All such rights should be supported by the cross charge, which should extend to the sole risk operations.

4.2.2 Infrastructure on tenements

Any security taken over a mining tenement will include infrastructure affixed to the tenement.

[68] LexisNexis, *Halsbury's Laws of Australia* (online version), [170-60], citing *Sirr v Dwyer* [1984] WAR 326 and *Dry Creek Mining NL v Acton* (unreported, Coolgardie Warden's Court, 10 January 1989) noted (1989) 8 AMPLA Bull 48.

4.3 Rights under Joint Venture Agreements

The rights of a participant under an unincorporated joint venture include the rights against the manager, and the rights against other participants. They will form a critical part of any joint venture interest and a critical part of any financier's security package.

There are a large number of issues to consider in taking security over the choses in action associated with the joint venture:

(a) Obviously, it is critical that the joint venture agreement does not prohibit assignment and the creation of encumbrances. If that is so, no form of security can be taken. It is also critical that the joint venture agreement does not prohibit assignment. If assignment is prohibited, and a financier sought to take security by way of assignment, the assignment will be ineffective.

If the joint venture agreement prohibited assignment, but not the creation of encumbrances, the position is not so clear. There is some authority to suggest that it may be possible to take a charge (as opposed to a mortgage) over unassignable contractual rights.[69] However, P G Turner[70] has criticised the line of reasoning in those cases, and there must be sufficient doubt not to proceed down that path unless absolutely necessary.

(b) Rights under a joint venture agreement may also be unassignable because they are "personal" in nature. It has been suggested that many rights under joint venture agreements are personal in nature in the sense that a party's expectations of the outcomes when dealing with A may differ than when dealing with B (such as the right to participate in management committees, the right to approve budgets, the replace the manager and the right to determine when mining is to commence). This would clearly fail the often-cited test in *Tolhurst v The Associated Portland Cement Manufacturers (1900) Ltd*[71] that a right will not be personal if "it can make no difference to the person on whom the [corresponding] obligation lies to which of two persons he is to discharge it". Clearly, there will be a difference if A has better technical expertise than B; or A is more risk averse than B.

However, notwithstanding that rights are personal in nature, it is possible for the parties to evince an intention that their personal rights may be assigned.[72]

Accordingly, it is strongly advisable to ensure that the joint venture agreement not only does not prohibit the grant of security to financiers, but that it gives the joint venture participant the *right* to do so.

Where a participant has the right to grant security, it is often the case that it is only subject to certain conditions. Those conditions might include:

[69] See obiter comments in *Don King Productions Inc v Warren* [1998] 2 All ER 608, 631-633 (Lightman J) and *McGowan v Commissioner of Stamp Duties* [2002] 2 Qd R 499, 506-507 (McPherson J).

[70] "Charges of Unassignable Contractual Rights" (2004) 20(2) *Journal of Contract Law* 97.

[71] [1902] 2 KB 660, 668-669.

[72] See *Don King Productions Inc v Warren* [2000] Ch 291, 319.

- that the financier or "permitted chargee" enter into a deed of covenant in favour or the other joint venture participants containing an acknowledgement that the charge is to be subject to the rights of the other participants and that in the event of the financier or a receiver appointed by it exercising any powers of enforcement, they will be subject to the joint venture agreement;
- that the permitted charge be in a particular form;
- that the permitted charge only secure moneys or credit facilities obtained in relation to the joint venture project; and
- that the permitted charge be over the *whole* of the participating interest of the participant and not part of it (to prevent fragmentation of joint venture interests).

These situations are far more complicated than the situations considered in recent cases relating to unassignable contractual rights such as *Don King Productions Inc v Warren*.[73]

However, the general proposition arising from those cases seems to be that it is possible to create a proprietary right (being the chose in action) containing the conditions under which that right can be alienated. If those conditions are not met, then that right cannot be so alienated (at least in that manner).

It follows that if not all conditions are met, then there may be some danger that the alienation is ineffective, notwithstanding that consent from all parties is obtained (for example, through the deed of covenant).

If this is indeed the case, then prudence suggests that:

- the conditions specified in the joint venture agreement be limited to those which can be easily ascertained (for example, that a deed of covenant is entered into), or ensuring that the deed of covenant contains a self-executing mechanism satisfying the conditions contained in the clause granting the right to create security; and/or
- the other joint venturers expressly acknowledge that all conditions have been satisfied (or waived) and that the relevant security is effective.

4.4 Rights under State Agreement

If there are any State Agreements involved in the project, they are likely to confer valuable rights on joint venturers. These include the right to concessional treatment of state taxes and royalties, stipulations that executive discretions regarding security of tenure will be exercised in a particular way,[74] security of State services, such as road upgrades and other protections against later inconsistent executive action.[75] For

73 [2000] Ch 291.
74 Absent legislative ratification, these stipulations are likely to be ineffective as a fetter on legislative action.
75 See eg A Fitzgerald, *Mining Agreements* (2002).

example, assurances from governments may be sought with respect to: "production or export controls and planning and environmental discretions which might lead to mandatory changes in design or radical changes in methods of operation."[76]

To the extent that the risk of government activity affecting the project is reduced through State Agreements, the risk of unforeseen increases in development costs, operating costs, and taxes and the risk of delays in earning revenue will be reduced. State Agreements can therefore have a significant impact on financial ratios, and the ability to service debt.

In order for financiers to take effective security over rights under State Agreements, the State Agreement should contain an express permission to grant security. Ladbury states:

"(a) in as much as the agreement creates personal rights and obligations it may be unassignable without such a permission; and

(b) in the case of contracts between the government and a particular person or company, questions of public policy may additionally enter into account so as to preclude the assignment, by the person or company."[77]

4.5 Rights in relation to infrastructure

The recent situation in relation to coal ports on the East Coast of Australia, and the inevitable comparisons with iron ore operations in the Pilbara, have demonstrated just how important infrastructure issues can be in a mining operation.

It is one thing to extract product, it is quite another to deliver it to the point of sale. In the Pilbara, rail lines, rolling stock and port operations used by the major miners are owned and operated by those same major miners. This has enabled them to integrate all stages of production, from extraction to delivery to the ship's rail at the port. By contrast, mining operations dependent on multi-user facilities will be, to some degree, dependent on the facility operator and other users of that facility, so that integration of operations is not really possible.

Another important factor is that, in the Pilbara, infrastructure expansion decisions can generally be undertaken by mine owners; whereas in the case of multi-user facilities, expansion decisions are dependent on reaching consensus with other users (who are often competitors), the facility operator and the relevant competition authority if the facility is regulated.

Financiers should therefore be acutely interested in the economics of the infrastructure equation, as that is likely to affect initial sales targets, and the ability to expand in the future. The recent experience seems to be that infrastructure

[76] R Ladbury, P Fox and G Nettle, "Current Legal Problems in Project Financing" *Australian Mining and Petroleum Law Journal* (1979) 3(1) 139, 151.

[77] Ladbury also recognises this point in R Ladbury "Joint Venture Financing – Lender's Requirements" (1981) *Energy Law* 1981 (International Bar Association Seminar Proceedings).

capacity in a period acts as a ceiling for the level of sales that can be made during that period, and therefore a ceiling on the amount of revenue that can be generated.

Whilst we do not intend to discuss infrastructure issues in detail, the above discussion demonstrated that it is critical that financiers obtain effective security over infrastructure or infrastructure usage rights. The type of security taken by financiers will obviously depend on the nature of the infrastructure rights utilised.

On one hand, the relevant security will constitute security over rights under access agreements (which will obviously depend on the terms of the access agreements). In such cases, the analysis is similar to that for the taking of security in respect of rights under the joint venture agreements. The financier will need to carefully scrutinise the access agreement to determine the circumstances in which usage can be curtailed or interrupted. These circumstances not only include force majeure or operational failure, but also where the users decide to expand the infrastructure facility.

On the other hand, where the rail, port and power assets are owned by the joint venturers, the relevant security could constitute the taking of security over the hard rail, port and power assets. This could include the taking of security over ancillary mining tenements, such as general or special purpose leases, and will be dependent on the terms of the applicable mining legislation or State agreement.

Having said that, third party issues can also be relevant, as can be deduced from the recent decision in *BHP Billiton Iron Ore Pty Ltd v The National Competition Council.*[78] That case concerned an application for access to rail assets under Pt IIIA of the *Trade Practices Act 1974* (Cth). The rail owner, BHP, objected to the application on a number of legal grounds, but it is understood that the economic reason for the objection was that the use of the rail line by a third party could endanger the efficiencies it enjoyed through integration of its operations. If BHP had been project financed, the decision would have been of great relevance to financiers.

Sole risk provisions are also relevant to an analysis of the limitations that infrastructure can impose on a project. Let us assume that:

(a) A, B and C are joint venture participants of which A is the manager;
(b) C has project financed its participating interest; and
(c) A and B pursue a development opportunity without C, pursuant to the sole risk provisions.

If they do so, and the result is that the total operations of the joint venture and the sole risk participants exceeds existing infrastructure capacity, then there will obviously be a problem. Even if capacity is not exceeded, some of the manager's resources will be diverted to the sole risk operations, and there is potential for increased delays due to scheduling issues and bottlenecks (C, on the one hand, and A and B on the other, now having separate interests).

This gives rise to similar economic issues, as those faced in the *BHP Billiton Iron Ore* case described above, with the consequent need to divert resources

[78] [2006] FCA 1764.

towards resolving disputes with respect to matters such as scheduling, capacity entitlements during force majeure/operational failure, liability to contribute towards infrastructure expansions, and capacity entitlements during the period in which construction works for expansions are undertaken, amongst other things.

The situation would be exacerbated if there were not a single manager across the joint venture and the sole risk operations. Let us assume that C were the manager of the project, but C did not wish, or was not permitted, to participate in the management of the sole risk operations. In such cases, there would need to be a means for resolving disputes between C, and the manager of the sole risk operations, say, A (who would, in effect, be competing users of the same infrastructure, given their different ownership entitlements).

For that reason, a financier should ensure that the potential for sole risk operations to affect joint venture operations is proscribed. For example, the joint venture agreement could include:

- provisions for notification of intention to undertake sole risk operations in detail;
- a right for the manager or participants to object if sole risk operations are likely to interfere with existing operations;
- a covenant not to interfere with existing operations (although once a decision to undertake sole risk operations is made, it is likely to be very difficult to unwind the effect of those operations, or reduce the level of interference, without the loss of, or the incurrence of, very significant levels of capital expenditure); and
- appropriate indemnities.

4.6 Insurance

In any project financing, rights in respect of insurances form a critical part of the security package. After all, if the financiers are dependent on the existence of an operating plant to repay a debt, and that plant is damaged or destroyed, then that will be a matter of no little concern to financiers.

Doyle discusses in detail project financiers' requirements in relation to insurances.[79] These include:

- that the security trustee be a joint insured, and a sole loss payee;
- the insurer waive rights of set-off or counterclaim against the financiers;
- inclusion of clauses to the effect that acts, errors or omissions, misrepresentations or non-disclosure of one insured, will not prejudice the rights of other insureds (so-called "non-vitiation clauses");

[79] See P Doyle,"Project Finance: Issues for Project Sponsors and Project Contract Counterparties" [2003] *AMPLA Yearbook* 84, 123-126.

- cure rights for financiers, in the event of breaches by insured parties of the terms of their insurance policies.

In joint venture arrangements, insurances are normally effected by the manager on behalf of all participants, as this is normally more cost-effective than would be the case if each joint venturer took out separate insurances.

Where none of the parties to the joint venture agreement have entered into project financing arrangements in relation to their participation, the obligations of the manager with respect to insurances are likely to be stated in broad and imprecise terms, for example, that the manager effects such insurances as are appropriate for a business of that type, or such insurances as are determined by the management committee. Project financiers are not likely to accept that level of imprecision.

There is therefore likely to be discord where only some of the participants have project financed their participation. The other participants are not likely to wish to be bound by the same terms as the project-financing participants, as this reduces flexibility and may increase cost. Much depends on the bargaining position of the parties.

If the project financed participant is the largest participant, and holds a majority stake, the other participants may have no real choice but to accept the strictures imposed by project finance.

On the other hand, if the project financed participant is only a minority participant, the participant may not be in a position to force the issue at the joint venture level. Furthermore, during the life of the agreement, its limited voting stake may not enable it to control insurance decisions of the joint venture. It is possible for a project financier to impose more stringent obligations on the project financed participant under its finance documentation, however, this will be of limited value if, once again, the participant could not force the issue at the joint venture level.

There are a number of possible solutions:

(a) the joint venture agreement could contain the detailed requirements and provide that insurance decisions require a super-majority decision of the management committee (this is only likely to be acceptable where the minority participant has a large minority stake (eg 49%)); or

(b) the joint venture agreement could provide that a participant has the right to obtain additional or separate insurance at its own cost, provided that it does not interfere with, or prejudice, the insurances effected by the manager. In such case, close attention needs to be paid to the interaction between the additional or separate insurance, and the insurances effected by the manager.

Sometimes, participants may wish to self-insure. If so, there will again be a discord between the requirements of a project financing, and the requirements of the self-insured participant. In such cases, the joint venture agreement needs to provide sufficient flexibility to enable the participants to pursue their different programs.

4.7 Product

As a general rule, a mining tenement holder does not obtain title to product until the product is recovered.[80] At the point of recovery, however, the product is in the possession of the manager (as the manager will conduct mine operations). The product will normally continue to be in the possession of the manager until it is delivered to either a third party carrier (such as a shipowner or ship operator) or a purchaser.

Throughout the process, however, the product is likely to be maintained as an undivided bulk. This means that it is not possible for the joint venturer to have title to specific product. Rather, it will have a share as a tenant-in-common in the bulk.[81]

The right to take a share of the product out of the bulk should be structured as a proprietary right, but it is likely that that share will fluctuate according to the terms of the joint venture agreement. Of course, it will be crucial for financiers, that the right to take product is proprietary (that is, that it will be enforceable in the event of the manager's insolvency) and that they be satisfied with the initial share of the product, and the circumstances in which that share might fluctuate.

4.8 Sales Contracts

As Ladbury states: "Sales contracts assume importance where the nature of the product itself gives rise to market risk".[82] The analysis for financiers; taking security is similar to that for the taking of security in respect of rights under the joint venture agreements.

4.9 Bank Accounts

Financiers should take security over the bank accounts of the borrower. It is not proposed to deal with all of the issues associated with the financier taking security over bank accounts, as that subject is more appropriate for a more general project financing paper.[83]

[80] There are some exceptions to this. For example, in Western Australia, it is possible that a person having an interest in land that was alienated by the Crown in fee simple before 1 January 1899, could own minerals other than gold, silver or precious metals prior to extraction, because such minerals were not reserved to the Crown: see s 9(1)(b) of the *Mining Act 1978* (WA). The position depends on whether the Crown reserved ownership of minerals to itself, and the terms of any title. The position may also be impacted by native title rights, depending on whether native title rights to sub-surface minerals are recognised.

[81] See R M Goode, *Proprietary Rights and Insolvency in Sales Transactions* (2nd ed, 1989) (especially Ch 1) for a good discussion of the characterisation of rights to take goods.

[82] R Ladbury "Joint Venture Financing – Lender's Requirements" (1981) *Energy Law* 1981 (International Bar Association Seminar Proceedings) 269, 282.

[83] See P Doyle, "Project Finance: Issues for Project Sponsors and Project Contract Counterparties" [2003] *AMPLA Yearbook* 84; Y Cho, "The Fixed and Floating Charge" in Mallesons Stephen Jaques (ed), *Australian Finance Law*, (5th ed, 2002).

However, one issue specific to joint venture relationships is the extent to which the cross charge extends to bank accounts.

It is normally expected that a financier's security over bank accounts into which proceeds are paid is first ranking. This position can conflict with the position in which a cross charge extends not only to sales contracts, but also their proceeds (as the cross charge will normally be first ranking). That is because it cannot be stated with any certainty when an item of property ceases to be a "proceed" (particularly if it is paid directly into the bank account), and when it becomes a deposit in a bank account (comprising a chose in action against the bank).

For that reason, it is clearer if the cross charge does not extend to proceeds in respect of sales contracts, and clearer still (from the financiers' perspective) if the cross charge ceases at the mine site in respect of production and does not extend to the sales contract at all. An alternative would be to provide that the cross charge were second ranking with respect to the sales contract proceeds and perhaps, the sales contracts.

4.10 Rights under Cross Charge

The financiers should take security over the participant's rights as cross-chargee. This enables the financier to reach into the joint venture interest of the other participants (and their other assets the subject of the cross charge), in the same way as the participant. The analysis for financiers taking security over cross charges is similar to that for the taking of security in respect of rights under the joint venture agreements.

4.11 Sponsor Completion Covenants

Recall that a financier in a project financing might seek some form of recourse against credit-worthy sponsors as a means of obtaining comfort that the sponsor will not simply allow the project vehicle to default on its obligations. This is an exception to the limited recourse principle.

A joint venture relationship can complicate the position with respect to sponsor completion covenants, and limit the range of acceptable sponsor recourse. Even if a sponsor might otherwise accept some level of recourse against itself for the default of its own project vehicle, it is likely to hesitate before accepting any risk for anybody else's project vehicle, absent any special circumstances.

It is possible to structure the recourse such that it applies only to the sponsor's own project vehicle (such as a financial guarantee of the project vehicle's debt), an undertaking to ensure the project vehicle is fully funded until the project is completed, or a guaranteed purchase of product.

However, it is not possible to obtain an undertaking to complete the project, unless the sponsors are willing to obtain a degree of joint and several liability in relation to each other. It is very difficult to see how one can sensibly *severally* undertake to complete a project.[84]

4.12 Joint Venture Interests

It is apparent from the discussion above and in section 3.3, that the assets of the joint venture are likely to be of more value to the other joint venture participants when they are all committed to the joint venture.

This is also most likely to be true for the project financier. The project financier is dependent not only on all the physical and financial factors affecting any other project financing (eg the plant operating at a commercial level, sales being made at the requisite price levels), but also on the participant's rights vis-à-vis the other participants.

For that reason, the relationship of the parties under the joint venture agreement, and in connection with the joint venture, are all important. As Ladbury said:

> "The joint venture documentation may be vital to the form of financing. It is obviously essential that the proposed form of financing be compatible with the joint venture documentation and vice versa."[85]

5. JOINT VENTURER'S ISSUES

5.1 Financiers During the Negotiation of the Joint Venture

It is natural for parties not to wish to involve financiers (or their lawyers) in discussions until the parties are satisfied that the main commercial terms of the deal have been worked out. Obviously, there will be input (likely to be perceived as interference) in the commercial terms of the deal, as well as additional costs.

However, if financiers are not involved in an early stage, there is a danger that the requirements of financiers, will be ignored during the formative stages of the joint venture. A minor or weak joint venturer may then find itself with a joint venture agreement that is not "bankable" as such, thereby precluding project financing alternatives at a reasonable cost.

From a borrower's perspective, it is essential that the likely prerequisites be kept in mind at an early stage when developing the joint venture structure and when drafting the joint venture documentation so that, to the greatest extent possible, future problems are minimised or eliminated, or otherwise catered for. This is said recognising that it will almost never be possible to contemplate all

[84] R Ladbury "Joint Venture Financing – Lender's Requirements" (1981) *Energy Law* 1981 (International Bar Association Seminar Proceedings) 279, 282.

[85] R Ladbury, "Recent Trends in Limited Recourse Financing with Particular Reference to Limited Recourse Loans, Production Payments and Forward Sale and Purchase Agreements" (1979) 2(1) *Australian Mining and Petroleum Law Journal* 69, 79.

possibilities. On the other hand, however, it should be possible to limit some of the more objectionable aspects if financing is likely in the short term.[86]

Jon Carson said in the second commentary to Milliner's paper:

> "There is an unavoidable and fundamental conflict between the interests of the lender to and the interests of the joint venture participants. The lender of course ultimately expects to be repaid the moneys advances with interest or profit and wishes to be able to enforce its securities effectively should the need arise by either sale of the secured interests, or by appointing a receiver to receive the proceeds of production or more usually the proceeds of sale of production, or selling the secured interests, or both. The joint venture participants will wish to, as effectively as possible, isolate a default, minimise its impact upon them and the joint venture and ensure continued operation of the project."[87]

However, it is our view that the interests are perhaps not so fundamentally opposed.

In a project financing, whilst a financier will wish to preserve the full range of remedies available to it, financiers' interests are likely to be best served if the project is constructed and then operated as planned. It is most likely to be only the cash flow that is generated from a healthy project that will be sufficient to service debt. It is likely only to be in rare cases that a financier will realise sufficient value from a fire sale of project assets to discharge debt. Therefore, a joint venture agreement which is fair to all parties will also be of value to the financiers.

5.2 Relationship of Participants

Before analysing the terms of the joint venture, it is first necessary to consider the relationship of the parties. Let us assume a joint venture:

- between A and B, where A has a participating interest of 60% and B has a participating interest of 40%; and
- where A is the manager.

Even if all other relevant factors were equal, a project financier to A would be in a better position than a project financier to B. That is because A is likely to have more control over the operations of the joint venture as a majority participant and operator than B. A could provide more normal project finance covenants to the financiers (that is, a firm covenant to ensure things occur), whereas B is only able to undertake to financiers to exercise its rights under the joint venture with a view to achieving a particular effect. Where a matter requires a vote, B can only

[86] See M James, "Comment on Taking Security Over Joint Venture Interests" Paper presented at the 1988 Australian Mining and Petroleum Law Association Limited (WA Branch) Conference, Session No 2 Paper 5, 10.

[87] J Carson, "Second comment on Taking Security Over Joint Venture Interests" Paper presented at the 1988 Australian Mining and Petroleum Law Association Limited (WA Branch) Conference, Session No 2 Paper 5, 2.

undertake to vote in a particular way. That vote may, or may not, be carried, depending on the voting provisions under the joint venture agreement. Where a matter falls within the manager's jurisdiction, B can only exercise its rights under the joint venture agreement to procure that the manager acts in the way required by the joint venture agreements. The manager is likely to be given wide powers (as an incident of their role as manager); and B is likely to have little day-to-day control over A. Hence, a financing covenant requiring B to exercise rights to require the manager to act in a particular way may be of limited or no value.

From the preceding analysis, it can be seen that there is almost an inconsistency between the tight controls required during a project financing (particularly during the constructions phase) on the one hand, and minority participation (with its attendant lack of control over the project) on the other. However, there are a number of ways in which this issue can be tackled:

(a) The joint venture agreement can provide that the decisions likely to be of most concern to financiers require decisions of the management committee (rather than the manager) and that the voting requirements are such that B's vote is required to carry any of those decisions, for example, decisions of the joint venture to abandon the project, to undertake an expansion, or otherwise incur significant discretionary capital expenditure. There will obviously be a tension between the requirements of A and what B anticipates its financiers will need. If B's financiers are not at that time involved in the negotiations, B will need to be fairly confident that it is able to anticipate the requirements of its financiers, or it will suffer the consequences (eg through requirements for greater sponsor support, or tighter financing terms or in worst case scenarios, no project finance at all).

(b) As long as B can vote against any decision to shut down, or significantly curtail operations, financiers may be less concerned with the comparatively weaker position of B during the operations phase, as much of the scope for making decisions with which financiers are concerned, will have passed. However, financiers will still need to be comfortable that a decision cannot be undertaken which binds B to undertake any expenditure it cannot afford. That is, if a major expenditure is proposed:
    (i) B is able to block the expenditure;
    (ii) B is not obliged to undertake the expenditure (that is, the decision becomes one to which the sole risk provisions apply); or
    (iii) The financier is given comfort that B has sufficient access to sponsor funds to be able to make the expenditure.

The positions in paragraphs (a) and (b)(i) above are likely to be progressively less acceptable to other participants, as the participating interest of B reduces.

By contrast, a project financier to A will want A to be able to make as many decisions as possible without influence from B, and thereby ensure that that financier can control A, and the project, through its undertakings in the finance documentation.

5.3 Interference with Operations

However, one always needs to be careful to ensure that the ability of B to protect its interests under the voting mechanisms and other protections in the joint venture agreement, does not inhibit the manager's ability to operate the project in an effective manner. After all, it is likely to be only the healthy project that is capable of generating the revenues sufficient to service debt.

As Martin James said in his commentary on Milliner's paper:

> "A constant problem from a lender's viewpoint are provisions which can or may prevent necessary decision making processes occurring or which can lead to the project being stalled. For the lender to assume all or any of the project risks, it must be confident that the project is viable and that, whilst it remains viable … operations will proceed. A right of veto on anything but the most significant matters (such as project expansion and project abandonment) is inconsistent with the lenders position, as is any position that can lead to a single joint venturer preventing day to day operations continuing. Joint Venturers must be willing to forego an individual right to be involved in any and all decision making processes, and ultimately leave everything to a question of majority control. It is the single most frustrating element from a lenders viewpoint to find that the operations of the project are frustrated by joint venturers as opposed to third parties."[88]

5.4 Loss of Voting Rights

Nonetheless, from the discussion above, it can be seen that provisions which provide for a loss of voting rights following a default are critical to financiers, as they result in the loss of the ability of the financier to control or influence the project through the ability to direct the participant to vote in a particular way.

For that reason, financiers require a reasonable opportunity for the defaulting participant and its financier to cure the default before voting rights are lost.

However, financiers should not insist that there be no loss of voting rights. Financiers to non-defaulting participants will benefit from the exclusion of the defaulting-participants from the decision-making process.

5.5 Identity of Manager

In any project financing, a financier takes the risk that the borrower has the necessary technical expertise and financial wherewithal to construct, or supervise the construction of, the project and operate the project. In relation to any decision to fund a borrower, Milliner said:

[88] M James, "Comment on Taking Security Over Joint Venture Interests" Paper presented at the 1988 Australian Mining and Petroleum Law Association Limited (WA Branch) Conference, Session No 2 Paper 5, 10.

> "In general the lender's decision should have given significant attention to the technical expertise and management experience of the borrower in relation to the project. If this is the case it is arguably inconsistent for the lender to propose securities that restrict the borrower from doing many of those things it has determined the borrower has the experience and expertise to do."[89]

However, in our example above, a project financier to B will be taking the risk that A has the necessary technical expertise and financial wherewithal in relation to the project. This may itself not be a problem if A is well known to the project financier. However, the project financier needs to scrutinise the provisions in the joint venture agreement to determine to what extent A can resign, or be removed, and how a replacement manager might be appointed. The extent to which B has control over this process is important. It may be unacceptable for B's financiers to have no ability to influence the appointment of a replacement manager. On the other hand, the acceptability to the other participants of allowing B to have influence over that decision will reduce as B's interest declines.

A project financier to A is faced with different issues. If the project financier has provided finance to A on the basis that A will have day-to-day control over the project as manager, the financiers will wish to limit the circumstances in which A can be replaced. A's financiers are also faced with an issue unique to the position of financiers to the operator. That is because liabilities to third parties are often incurred directly by the manager.

The view is often taken by managers that in the case of "major" contracts, they will enter into contracts on the basis that they are agent for disclosed principals, and that the liability of principals is expressed to be several. However, other contracts may be entered into without disclosing the existence of the principals at all.

In such a case, the third party could take action against A for the full amount of the liability. This could cause timing delays in recovering money from B, or worse, where B refuses to, or is unable to, contribute to the liability.

In addition, there may be a tortious liability (for example, if the proportionate liability regimes apply), where primary liability, or most of the primary liability, falls on the manager. In such cases, there is a risk of exposing A's assets to a claim by a third party in respect of liabilities that should properly be borne severally. A will almost certainly be able to claim from B under an indemnity, A still takes the risk of recovery from B. This may not be a risk that financiers to A have factored into calculations.

To obviate the risk, if tax considerations permit, it may be appropriate for the participating interest and other assets (and the debt) to be quarantined within one entity, say A1, and for the manager to be a separate sibling entity, A2.

[89] R Milliner, "Taking Security Over Joint Venture Interests" Paper presented at the 1988 Australian Mining and Petroleum Law Association Limited (WA Branch) Conference, Session No 2 Paper 5, 54.

5.6 Identity of other Participants

In joint venture project financings, more so than in other project financings, the financier is exposed to co-participant risk. As Ladbury states:

> "The co-participant risk is the risk arising out of the number of and strengths and weaknesses of the co-participants. … If one joint venturer is significantly weaker financially than the others, this may give rise to particular problems in the case of a default by one of the joint venturers. … The risk from the lenders' viewpoint is that additional funds will be needed to complete the project and protect the advances already made."[90]

There are many provisions which can be inserted into a joint venture agreement to protect a participant against default by another participant, including loss of voting rights, loss or rights of production/operator's liens and forfeiture, abatement or dilution and compulsory contribution by non-defaulting participants. The unavoidable difficulty with these provisions, from a financiers' perspective, is that in most cases, the non-defaulting joint venturer will be obliged to contribute extra funds, if the defaulting joint venturer is unable to do so, in order to complete the project, or keep the project functioning. This poses obvious problems for financiers, as they may only have contemplated a specified level of construction costs and cost overruns attributable to construction risk factors only, or a specified level of operating costs.

As Milliner said: "If the borrowing joint venturer is obliged to pay additional sums to keep the project operating where another joint venturer has defaulted, the lender may find itself called upon to put up additional funds because its borrower cannot find the additional money itself."[91]

For that reason, financiers need to be satisfied with the ability of co-participants to fund their share of the costs of completion and operation of the project, and their willingness to do so, or alternatively, the level of funding available to the participants they are funding.

Some of the ways in which the former effect can be achieved include:

(a) satisfying oneself of the technical expertise, financial wherewithal and commercial reputation of the co-participants; and

(b) ensuring each co-participant provides sponsor support in favour of the participant being funded. This can be a parent company guarantee of the joint venturers' obligations, if the joint venture agreement contains a covenant to complete the project, or it can take one of the forms described in section 1.4(f) above, except that it is in favour of each other participant.

The latter effect can be achieved through paragraph (b) above, or through ensuring each other participant has standby funds available to it (for example, through a project facility with significant headroom), or through a standby facility, and ensuring there is a covenant to use such finance for the purposes of the joint

90 R Ladbury, "Recent Trends in Limited Recourse Financing with Particular Reference to Limited Recourse Loans, Production Payments and Forward Sale and Purchase Agreements" (1979) 2(1) *Australian Mining and Petroleum Law Journal* 69, 71.

91 Milliner, op cit n 1, 26-27.

venture. Of course, in each such case, the co-participant risk will only be proscribed to the extent of the additional funding of that joint venture available to, and committed to, the joint venture.

5.7 Loss of Rights to Production

We mentioned these provisions in section 3.4, in the context of a discussion on whether joint venturers held any proprietary rights in the assets of another joint venturer.

Financiers will be concerned with these provisions to the extent that:

(a) there is not an insufficient opportunity for the defaulting participant (or its financier) to remedy the default before the loss of rights commences;

(b) the loss of rights is penal in comparison to the default committed.

However, financiers will also benefit from these clauses to the extent that their participant is not the defaulting participant. If a non-defaulting participant contributes extra expenditure to remedy the default of another participant in order to keep the project operating (which they may have no real choice, but to do), they need to be properly compensated.

5.8 Dilution and Abatement

Again, a similar principle applies as for loss of rights of production. Financiers will not want to see their own participants' interest capable of being diluted or abated at a penal rate, or without an opportunity to remedy. A complete forfeiture of a joint venture interest will, of course, along the same line of thinking, be unacceptable. As noted in section 3.5, it would be a brave financier indeed that relied on the doctrine of relief against forfeiture to prevail against the clear terms of the joint venture agreement.

On the other hand, a financier to a non-defaulting participant will benefit from dilution and abatement clauses.

5.9 Balance

From the preceding discussion, it can be seen that financiers will often benefit from a sense of balance (balance in the technical expertise and financial wherewithal of the participant. and balance in the joint venturers rights amongst themselves). As Milliner said:

> "Certain … default related provisions of the joint venture agreement will be of concern to lenders not only because they relate to the borrower as a defaulting joint venturer but also because they are relevant to the borrower as a non-defaulting joint venturer."[92]

[92] Milliner, op cit n 1, 26.

Along the same lines, Martin James said:

> "The immediate loss of rights (such as to vote and to receive production) by a defaulting joint venturer under the joint venture document is an immense problem for lenders. The effect of such provision is that the lender has not time in which to consider the consequence of default and the economics of the project, and is obliged to make an immediate decision to either fund the call of the defaulting party or allow the borrower to suffer consequences under the joint venture document which will prejudice the position of the lender. Reasonable provisions should be inserted in the joint venture document providing that the loss of rights should be postponed for a reasonable time after default so the lenders have an opportunity to consider the matter and to cure that default.
>
> …
>
> Whilst it is true that remedies of the joint venturers inter se upon the occurrence of default need not be controversial so far as regards the lender (after all, the provisions are part of the lenders' security vis-à-vis the other joint venturers), there are occasions where such provisions go beyond what is acceptable to lenders. Dilution, for example, may be at such a penal rate, or commence quickly, so that a lender cannot accept the risk to its security position of a default by the borrower. 'Withering', forfeiture and purchase provisions may also cause similar difficulty."[93]

6. STRUCTURING FOR DEFAULT

6.1 General Comments

If a joint venture is to be bankable it must be structured so that there is a mechanism which enables each joint venturer to ensure that each other joint venturer pays its proportionate share of joint venture expenses (usually in the form of calls by the manager) and that there is a procedure in place to enable other joint venturers to contribute any shortfall to prevent the venture failing because a venturer fails to meet its calls. As part of this process, the default procedure must allow the non-defaulters to recover their additional contributions and ultimately, if necessary, rid the joint venturer of the non-performer.

The methods for dealing with default are manifold and their appropriateness very much depends on the nature of the venturers and the particular facts and circumstances of the venture. Essentially they are:

(a) suspension of voting rights and loss of the right to receive joint venture information;

(b) loss of the right to production;

(c) forfeiture of the defaulter's interest either in whole or by a gradual dilution process;

[93] M James, "Comment on Taking Security Over Joint Venture Interests" Paper presented at the 1988 Australian Mining and Petroleum Law Association Limited (WA Branch) Conference, Session No 2 Paper 5, 10.

(d) a right or option on the part of the non-defaulters to acquire the interest of the defaulter, usually based upon some form of valuation, often at some kind of discount to reflect the disruption caused by the default; and
(e) a cross charge which enables the non-defaulters or the manager, acting on behalf of the non-defaulters, to take possession of the defaulter's interest and ultimately to sell that interest.

Each of the methods has been the subject of detailed analysis (whether in this paper or elsewhere) and so it is proposed to confine this part of the paper to a few general observations and to discuss in detail some particular issues which may be encountered on default.

The first point to make is that often the joint venture agreement will provide for more than one remedy because the circumstances in which the default occurs may vary and the venturers (and derivatively their financiers) may want to be able to take action which is appropriate in those circumstances. For example, if the venture is progressing well, the non-defaulting venturers may wish to acquire the interest of the defaulter or, if it is not, they might want to sell the defaulter's interest and sue for any balance. Often the personal position of a non-defaulting venturer may condition its response to the default, for example, if it is short of cash it may not wish to acquire the venturer's interest. It may well be that in some cases a dilution mechanism may not be an appropriate way to deal with defaulters because a dilution may allow the defaulter to retain the bulk of its interest while the non-defaulters and their financiers shoulder the burden of funding the project at a critical time. As part of its due diligence every financier of a venturer in a joint venture will wish to be satisfied that the default remedies under the joint venture:

(a) operate fairly against its venturer if it becomes a defaulting venturer; and
(b) do not disadvantage its venturer if another venturer becomes a defaulting venturer.

The second general point to make is that financiers will generally want their borrower's rights against defaulting venturers to be capable of operating effectively without undue risk of challenge or delay when exercised. For example, a joint venture agreement which simply provided for forfeiture without compensation would be a concern to a financier. This is because, if the provision worked, it would threaten the financier's position if the venturer which it was financing defaulted and, if the defaulter were another venturer, there would always be a doubt as to its effectiveness. Accordingly, a default mechanism involving an outright loss of a defaulting venturer's participating interest is unlikely to be welcomed by a financier.

Our final general observation is that many joint ventures do have appended to them a financier's deed of covenant which regulates the rights of a financier to a venturer and the other venturers. In many cases, these are fairly basic documents and do not generally contain rights to notices and other information for the financier, nor provide for a step in regime. When structuring joint ventures it may be a good idea for the needs of financiers to be considered, particularly where the joint venture consists of a combination between large venturers, who will not be dependent on project financing, and smaller venturers, who require project financing to fund their interest.

6.2 Clogging the Equity of Redemption

The uncertainty and complexity of forfeiture and acquisition remedies has made the cross charge the primary weapon for the non-defaulter in a producing joint venture. As a general rule, under a cross charge it is a straightforward process to take control of a defaulter's interest and, if necessary, to exercise a power of sale. However, a lot of joint venturers wish to have their cake and eat it too when it comes to default. It is by no means uncommon to see a joint venture agreement which provides for the non-defaulting venturers to have a right or option to acquire the interest of the defaulter and also to have a cross charge. In a perfect world, the non-defaulters could then decide whether or not to exercise the power of sale or to exercise other remedies such as the appropriation of the defaulter's right to product or the acquisition of the interest of the venturer for value. However, there is an issue as to whether a disgruntled defaulter could challenge the exercise of the option to acquire on the grounds that it is a clog on the defaulting venturer's equity of redemption under the cross charge. If such a challenge were successful, the non-defaulting venturers would not be able to exercise the right or option to purchase and would be restricted to exercising their rights under the cross charge.

One limb of equity's protection of the mortgagor's or chargor's right to recover the secured property on satisfaction of the secured obligations, is the principle that the mortgage or charge cannot be made irredeemable. Accordingly, it is not permitted in the ordinary course for the mortgagee under a mortgage also to have a right or option to acquire the mortgaged property because the exercise of the right or option would make it impossible for the mortgagor to redeem its property on satisfaction of the obligations secured by the mortgage. The classic illustration of this is the case of *Samuel v Jarrah Timber and Wood Paving Corporation Ltd.*[94] That case involved a mortgage of debenture stock granted at the same time as an option to purchase that stock. Because of this, the option was struck down as offending the right of a mortgagor to recover the mortgaged property upon satisfaction of the secured obligations. This was notwithstanding that, as the Earl of Halsbury acknowledged, it was a perfectly fair bargain made between the two parties to it, "each of whom was quite sensible of what they were doing".[95] Not surprisingly, in light of this rule, some commentators[96] have expressed grave reservations about the ability of a joint venturer to simultaneously have a cross charge charging another venturer's participating interest in conjunction with an option to purchase that participating interest.

In *G and C Kreglinger v New Patagonia Meat and Cold Storage Company, Ltd*,[97] the House of Lords set out to confine the ambit of the clogging doctrine and its related principles while leaving its fundamental elements in place. Among other things, it was recognised that an option to purchase was not necessarily a

94 [1904] AC 323.
95 Ibid 325.
96 K D MacDonald, "Joint Ventures: Breakdowns and Repairs Rights Upon Default" [1983] AMPLA Yearbook 209, 212-213.
97 [1914] AC 25.

clog on the equity of redemption. The cases since *Kreglinger* have, not always entirely successfully, been trying to tease out the true principles to be derived from that case. We think that it is fair to say that *Kreglinger* contains within it the basis to confine the clogging doctrine within sensible boundaries, but that the failure to say so more explicitly in the leading judgments in subsequent cases, has led to unnecessary confusion (lending some weight to Lord Mersey's comment in that case that the doctrine is like "an unruly dog, which if not securely chained to its kennel, is prone to wander into places where it ought not to be").[98]

In *Reeve v Lisle*[99] (a case pre-dating *Kreglinger*), it was held, and in *Kreglinger* it was recognised, that a mortgage transaction and an option could actually be separate and independent transactions, in which case the mortgage would be unaffected by the option and vice versa. At least one commentator[100] has suggested that this could be a basis for arguing that the clogging doctrine does not apply to cross charges and rights or options in the joint venture agreement to acquire a defaulting venturer's interest. Unfortunately, this argument is difficult to sustain because, as Lehane and MacDonald each recognise, both are conceived of as being alternatives for dealing with the defaulting joint venturer's default rather than being separate transactions.

In some recent Australian cases,[101] it has been suggested that the English authorities on clogging such as *Kreglinger* do not apply in Australia and that the coexistence of a cross charge and a right or option to purchase would only be at risk if it were unfair or unconscionable. We do not think that this reasoning is correct because we believe that the clogging principle has always been at least implicit in Australian law. Certainly, this was the view of the New South Wales Court of Appeal in *Wily (as administrator of Macquarie Medical Holdings Pty Ltd v Endeavour Health Care Services Pty Ltd*.[102]

We believe that the newer case law, such as *Wily*, provides a firm basis for the true nature of the clogging doctrine to be understood and that, when the principles of *Kreglinger* are properly applied, the clogging doctrine will be seen to have little application to cross charges and rights and options to purchase. The decision of the New South Wales Court of Appeal in *Wily* explicitly follows *Kreglinger*, but in a way which highlights that the clogging principle must be applied having regard to the circumstances of the case, and which indicates that a "clog" requires far more than the mere coexistence of an option and a mortgage.

In his judgment in that case, Meagher JA summarised the cases for both sides:

> "the appellant's case was that the final transaction agreed by the parties should be characterised as a secured loan, to which was appended an option

98 Ibid 46.

99 [1902] AC 461.

100 J R F Lehane, "Joint Venture Finance and Some Aspects of Security and Recourse" in R P Austin and Richard Vann (eds), *The Law of Public Company Finance* (1986), 523.

101 *Westfield Holdings Ltd v Australian Capital Television Pty Ltd* (1992) 32 NSWLR 194 and *Thomas v Silvia* (1994) 35 NSWLR 96.

102 [2003] NSWCA 321.

> to purchase. This option was in the nature of a 'collateral advantage' which is a clog on the equity of redemption and therefore unenforceable.
>
> The respondent's case was that the secured loan was collateral to the option, was incidental to it; that, as far as the respondents were concerned, the transactions were really concerned with the acquisition of an option to purchase."

Meagher JA concluded, consistently with the respondent's argument, that it was inescapable that the parties were concerned to enter into an option and that the secured loan was only ancillary to that. It is clear from this that in determining whether a mortgage and a right or option to purchase can coexist, it is critical to determine whether the transaction can truly be characterised as a "mortgage". Rather than considering whether there are two separate transactions, this involves having regard to the overall nature of the transaction to see if it is really a "mortgage" transaction in substance, or whether the mortgage is merely an ancillary part of the larger transaction. Having regard to the factual context in which the clogging cases were decided, we believe that this implicitly means that if the transaction cannot fundamentally be characterised as being one of financing or the provision of financial accommodation, then there is little scope for the clogging doctrine to operate.

It is also worth noting that the English Court of Appeal[103] has recently taken a similar line in relation to the clogging doctrine, in that case Lord Justice Jonathan Parker (continuing the "unruly dog" metaphor) said:

> "it has to be accepted that the "unruly dog" is still alive (although one might perhaps reasonably expect its venerable age to inhibit it from straying too far or too often from its kennel); and that however desirable an appendectomy might be thought to be, no such relieving operation has as yet been carried out….
>
> That said, it is in my judgment glaringly clear from the authorities that the mere fact that, contemporaneously with the grant of a mortgage over his property, the mortgagor grants the mortgagee an option to purchase the property does no more than raise the question whether the rule against 'clogs' applies: it does not begin to answer that question. As has been said over and over again in the authorities, in order to answer that question the court has to look at the 'substance' of the transaction in question: in other words, to inquire as to the true nature of the bargain which the parties have made. To do that the court examines all the circumstances."

When these principles are applied in the context of a cross charge and a right or option to purchase pursuant to a joint venture, we think that it is clear that the two can coexist. The cross charge in a joint venture is an ancillary instrument primarily intended to ensure that the venturers' calls are met and to enable the venturers to ensure the continued operation of the joint venture. Clearly, the right or option to acquire charged property is not the device of a "crafty moneylender" looking to turn what is essentially a mortgage transaction into an opportunity to

[103] *Warnborough Ltd v Garmite Ltd* [2003] EWCA Civ 1544, (2003) WL 22477262.

impose a further burden on the obligor. As a consequence, a cross charge should rarely, if ever, be affected by the clogging doctrine.

6.3 Administration Risk and Cross Charges

The ability to act immediately to protect the interest of the non-defaulting venturer following a failure to pay calls is a very important remedy for the non-defaulter and, derivatively, its financier. In part this is because:

(a) the cross charge enables the other venturers to recover any outlays that they may undertake on behalf of the defaulting venturer; and
(b) the cross charge will generally allow the non-defaulting venturers to take immediate control of the affairs of the defaulter (at least to the extent that they relate to the venture) on default.

Often this default will coincide with the insolvency of the chargor because, in many cases, insolvency is the cause of the default.

Since the introduction of administration as an insolvency remedy, the ability of a cross chargee to take decisive action on insolvency of the chargor has been at risk if the cross charge is not appropriately structured to deal with the administrator's powers.

The reflex reaction of directors of a company which is insolvent is to seek the appointment of an administrator under Pt 5.3A of the *Corporations Act*. The administrator on appointment then takes charge of the assets of the chargor. The holders of the cross charge may forestall the administrator taking possession of the charged assets but only if:

(a) the cross chargee acts within 10 days of the appointment or has already taken enforcement action before the commencement of the administration;[104] and
(b) the cross charge is over the whole or substantially the whole of the assets of the chargor.[105]

If the chargee does not act within the decision period or is not entitled to act then, notwithstanding the terms of the cross charge:

(a) the chargee may not exercise its powers under the charge, except if permitted by a court;[106]
(b) the administrator may deal with property the subject of a floating charge as if it had not crystallised;[107] and
(c) may dispose of other property the subject of the charge in the ordinary course of the chargor's business.[108]

In practice many cross charges do not allow the cross chargee to act when an administrator had been appointed because either:

[104] *Corporations Act 2001* (Cth) s 441A(1)(b) and s 441B.
[105] *Corporations Act 2001* (Cth) s 441A(1)(a).
[106] *Corporations Act 2001* (Cth) s 440B.
[107] *Corporations Act 2001* (Cth) s 442B.
[108] *Corporations Act 2001* (Cth) s 442C(2)(a).

(a) the cross charge charges only the joint venture assets and product and these are not the whole or substantially the whole of the assets of the chargor; or

(b) the cross charge is only enforceable on failure to pay a call and there is no call unpaid during the 10 day decision period.

Some, but by no means all, joint venturers are taking action to make their cross charges more effective. One way is to require in the joint venture agreement that cross charges charge all of the assets and undertaking of the chargor. In practice, this tends to force the joint venturers to hold their assets in a special purpose vehicle because they would not want their non-project assets to be subject to a charge for their project obligations.

An alternative which is being increasingly used is to supplement the cross charge with a featherweight floating charge. The featherweight floating charge, which is usually incorporated in the cross charge itself, is a floating charge over non joint venture assets and is enforceable only while the chargor is in administration. Importantly, the featherweight floating charge also permits any other security to have priority and any proceeds recovered under the featherweight floating charge, after deduction of enforcement costs and payments to prior securities, are held in trust for the chargor. The principal advantage of the featherweight floating charge is it allows the joint venturers the option of holding their joint venture interests as an asset of the sponsor or in a special purpose vehicle. Further, even if joint venture assets are held in a special purpose vehicle it still has the advantage that assets which are not joint venture assets or product (for example, loans or moneys in bank accounts) are, for most practical purposes, free of restriction.

We note that if the cross charge is given over all the assets and undertaking of the chargor it should make sure that any authorities to grant cross charges contained in its financing documents are wide enough to permit a cross charge extending beyond joint venture assets.

Finally, in dealing with the issue of administration, we note that where one of the venturers is the manager and, as such, holds the property on trust for the venture there is an issue as to how the manager can give a security to its financier over the whole or substantially the whole of its assets if it cannot charge the assets which it holds on trust for other joint ventures. It has been suggested by some commentators[109] that where assets are held in trust and are not charged by a person's charge, that person does not have a security over the whole or substantially the whole of the property of the company.

Cooper and Schembri argue that the definition of "property" in the *Corporations Act 2001* (Cth) (being "any legal or equitable estate or interest (whether present or future and whether vested or contingent) in real or personal property of any description and includes a thing in action") is sufficiently wide to include trust property. On the other hand, Ford[110] takes a different view and points

[109] David Cooper and John Schembri, "Application of New Administration Provisions to Trust Structures" (1993) 4 JBFLP 206

[110] H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (electronic full-text version) (Service 57 – September 2007) [26.121].

out that the case law on ss 555 and 556 of the *Corporations Act 2001* (Cth) does not treat them as extending to trust property despite the references in them to property. We think that Ford's is the better view.

7. COMMERCIAL ISSUES

7.1 Private Equity

For many years, it was considered unlikely that a private equity firm would seek to buy out a resources company. The reasons for this were many and varied; however, there were considered to be a number of obvious features of resources companies that made them unattractive to private equity firms. For example:

- revenues of true resources companies are dependent on commodity demand and prices, which were considered to be subject to cyclical fluctuations. By contrast, private equity firms depend on their buy-out targets having relatively stable revenues and cash flows, in order to service the acquisition debt;
- resources companies are perceived to be subject to significant "project risk", which is not desirable for private equity firms. Of course, this depends on the size of the target company and the size of its projects. A small or mid-size company with one or two large projects would have significant project risk.

In recent times, the first factor has appeared to have reduced in importance, as a view has taken hold in some circles that the only likely movement in prices of some commodities in the near to mid term is upwards. This confidence is, as we understand it, due to voracious demand caused by the boom in the Chinese and Indian economies, the fact that commodity supply is currently constrained, and the long lead time before new developments can increase supply and push down prices.

We cannot, of course, comment on whether this view is correct. However, we can say that it appears that private equity firms are increasingly interested in resources companies. In fact, there have been a number of recent instances in Australia and worldwide, where a private equity firm has made an offer to purchase, or has been successful in purchasing, a resources company.

Given the constraints of time and space, we cannot investigate these transactions in detail. However, one factor that we will consider (consistently with the theme of this paper) is the nature of any security given over joint venture interests.

7.2 Joint Venture Interest to Secure Non-Joint Venture Debt

One of the principles of a leveraged financing is that security in respect of all the assets of the bidding vehicle and the target companies be granted to secure the acquisition debt.

The obligation to procure that the target companies grant security is subject to a concept found in sophisticated leveraged financings, known as the "agreed security principles". These agreed security principles set out the principles to be applied in determining the scope and terms of the security package. Often, if an asset, or a contractual right, cannot be encumbered because of restrictions in arrangements with third parties, that asset or contractual right will simply be excluded from the security package. There will normally be a reasonable endeavours obligation (sometimes even a *qualified* reasonable endeavours obligation) to overcome the impediment to the grant of security, however, the end result could very well be that there will be no security over the joint venture interest.

In the joint venture scenario, the nature of any security which can be granted to secure the acquisition debt will be wholly dependent on the terms of the joint venture agreement. It is often the case that a joint venture agreement will restrict the creation of security (for example, where the original joint venture participants did not contemplate that any participation in the joint venture would be project financed), or provide that security over the joint venture only be granted to secure finance provided in connection with the "joint venture interest" as opposed to the wider corporate group.

In cases where the joint venture interests are small or immaterial, it may be acceptable to exclude the joint venture interests from the security package, in accordance with the agreed security principles. The exclusion of certain assets from the security package may cast doubt on whether the financier has a charge over "the whole, or substantially the whole, of the property of the company" for the purposes of Div 7 of Pt 5.3A of the *Corporations Act 2001* (Cth) (in which case, the financier would not be able to enforce the charge, if an administrator was appointed, as discussed above); but this risk seems not appear to dishearten financiers.

However, in cases where it would not be acceptable to exclude a particular joint venture interest, it will be necessary for all parties (including the financiers and their lawyers) to review the joint venture documentation and work together to develop an acceptable structure, as early as possible. In our experience, this usually does not happen in the short timeframes in which private equity transactions are undertaken. The private equity sponsor, or its advisers, will conduct the due diligence and provide the financiers with a due diligence report, usually only very shortly before the key commercial terms of the transaction are finalised in the commitment documentation. It is very unusual for the underlying documentation to be provided to financiers prior to signing the commitment documentation.

However, it may well be that the terms of the joint venture documentation will give rise to fundamental issues with respect to the security package, which could impact on pricing, or even the ability to undertake the transaction at all.

On the other hand, if the joint venture agreement provided that security could only be granted in respect of an acquisition of the joint venture interest, it may be possible to create a separate acquisition of the joint venture interest, by a subsidiary or sibling entity of the purchaser of the wider corporate group. The pre-emptive rights provisions would need to be reviewed, although often the pre-emptive rights provisions will not be triggered by a sale to a related body corporate. Alternatively, the terms of the joint venture agreement may be drafted in such a way that they do not prohibit the granting of security in respect of a notional purchase price for the joint venture interest, provided the secured moneys do not extend beyond that notional purchase price.

In any event, it will then be necessary to create separate security pools. This is not desirable for financiers, as it gives rise to a risk sometimes referred to as *cross-collateralisation risk*. Let us assume that security pool A secures debt of $600 and security pool B (comprising the joint venture interest) secures debt of $400. Let us then assume that only $550 is realised from security pool A; but $500 is realised from security pool B. Notwithstanding that the total amount recovered is $1050, there will be a shortfall of $50 (as the $100 excess on security pool B is, in fact, payable to the sponsors). It may be possible to impose an obligation on the sponsors to turn over any excess to the security trustee for security pool A (supported by trust mechanics), but whether or not this turnover mechanism contravenes the joint venture agreement will also require close analysis.

The above analysis is not, of course, intended to prescribe solutions to this issue, as any solution will be wholly dependent on the terms of the joint venture agreement. It is, rather, intended to highlight the importance of early identification and resolution of issues associated with the joint venture documentation.

As an aside, private equity firms will generally not countenance any requirement for sponsor support beyond the initial equity contribution, so this will generally not be available as a solution. Similar issues as those applying to leveraged buy-outs would apply to a secured corporate financing.

7.3 Permitted Security Interests

The terms of the finance documentation typically prohibit the granting of security interests by members of the corporate group, subject to a number of agreed exceptions (normally referred to as "permitted security interests" or "permitted encumbrances"). These restrictions could apply to all members of the corporate group, or only those that are required by the terms of the finance documentation to become members of the corporate group.

For both leveraged buy-out transactions and corporate financings involving mining groups (whether secured or unsecured), it will normally be necessary to include an additional permitted security interest relating to cross charges (to the extent restrictions apply).

One often sees the permitted encumbrance applying solely to a cross charge granted over the joint venture interest. This is deficient in two respects, as:

(a) There may be other relevant security interests created, such as a cross mortgage. There may also be security interests (or similar) created by the loss of rights of production clause, or the abatement or forfeiture clause. The latter is relevant because, even if there is debate as to whether they constitute registrable charges or security interests as a matter of law or equity, the restrictions applying to creation of encumbrances under the finance documentation, are normally drafted in a much broader fashion.

(b) The cross charge normally extends beyond the joint venture interest. It will almost always extend to product and insurances, and will usually also extend to sales contracts and, often, their proceeds.

If the hypothesis in this paper is accepted, the cross charge will also extend to all other assets (through the featherweight floating charge).

It may sometimes also be necessary to create a further permitted security interest relating to security over a joint venture interest securing project finance debt relating to that joint venture interest. This, of course, depends on whether the leveraged buy-out or corporate financier is willing to permit project financings (and if so, to what degree). It also depends, of course, on whether the restrictions apply at all to the entity undertaking the project financing.

7.4 Joint Venture Support for Financing

As a general rule it is unusual to see joint venturers borrowing collectively, even though there are advantages in doing so. The principal advantage is that a security given by all joint venturers gives a security over all of the joint venture assets and this single asset is significantly more valuable than the sum of the value of the joint venture interests if they were mortgaged separately. Other advantages include:

(a) the simplicity of dealing with an asset without having to deal with other venturers;

(b) the ability to ensure that the project is completed because the financiers have control of all aspects of the project.

In practice, collective financings rarely occur because joint venturers do not wish to be liable for the borrowings of their fellow venturers, particularly if there is a substantial disparity between each venturer's interest in the joint venture.

However, what is being seen increasingly in capital intensive projects such as coal and iron ore projects is for there to be a "big brother" financing in which a smaller venturer which has control of the resource invites another larger venturer to enter into a joint venture with it. In these cases it is a term of the joint venture that the larger venturer be obliged to procure financing for the smaller venturer; usually on a several basis from a syndicate of banks.

The benefits of such an approach were outlined in a previous AMPLA paper:

> "Large companies may also wish to participate in such financings so that they can lead the negotiations with lenders to attempt to minimise restrictions placed on the project as well as to enhance the commercial terms."[111]

Often the big brother is also obliged to provide additional mezzanine funding to enable the little brother to fund the balance of the funding required to be contributed by the little brother (that is, the little brother's equity contribution).

[111] M Davies, "Project Finance: Issues for Sponsors" [2003] *AMPLA Yearbook* 142, 154.

This obligation to provide support may also extend to committing to provide overrun support if there is a cost overrun in the construction of the project.

Big brother joint venture funding agreements are complex and difficult to negotiate because they involve putting in place a borrowing agreement at the very beginning of the joint venture, which may be many years ahead of when financing is actually required. It is therefore difficult to judge, at the outset, matters such as market appetite for particular kinds of financing, and market terms and therefore their impact on the joint venture.

Some of the issues which may arise in the negotiation process include:

- Is the obligation of the big brother to procure financing absolute or merely to use reasonable endeavours?
- To what extent should the little brother be consulted about banks being approached and kept informed of the progress of the process?
- To what extent should terms and conditions of the financing and intercreditor arrangements be subject to pre-agreed parameters or terms sheets?
- Should the little brother be obliged to accept a financing which has been procured for it?
- Is the big brother under fiduciary, as well as contractual, obligations and, if so, what are those fiduciary and contractual obligations?[112]
- What level of cooperation must be given by the little brother to assist the big brother to procure the financing?

8. CONCLUSION

As can be seen from the preceding discussion, financing on the security of a joint venture interest is a complex and involved matter. The difficulties are magnified several fold in the case of a project financing of a resources venture. Nonetheless, by systematically analysing the issues raised, financiers and their advisers have developed techniques to enable them to gain a sufficient degree of comfort to enable financings to take place.

Great progress has been made from the early days of joint venture financing when it was not even clear whether an unincorporated joint venture would be recognised by the courts! However, it is clear that many challenges remain. In this paper we have identified some, but by no means all, of the challenges and have provided some thoughts as to how those challenges should be met.

[112] Typically the big brother will attempt to avoid any suggestion that it owes any fiduciary obligation and that whatever duties it owes are purely contractual and are limited to those explicitly set out in the contract.

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