The Fox and the Henhouse: When Your Development Partner in a Real Estate Project is Also your General Contractor

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INTRODUCTION
Private investment in real estate may be broadly divided into two general categories: 1) acquisition of land with buildings that are already built, and 2) the planning and building of new projects. The latter category is commonly referred to as real estate “development.” Large and important real estate development projects throughout the world, whether they be for office towers, shopping centers, apartment buildings, hotels, mixed-use complexes and the like, require two things, generally speaking, to be successful: 1) considerable real estate expertise and organizational infrastructure in such areas as site selection, land acquisition, design, permitting, construction and construction management, marketing and leasing, and 2) an often significant amount of equity risk capital. In some instances, the party performing the day-to-day planning and execution of the project (i.e., the “Developer”) also has the wherewithal and desire to provide the risk capital. More typically, however, the role of Developer and principal financial sponsor are bifurcated and performed by separate parties. A Developer, after locating and conceiving the idea for a project, will seek out a financial partner (“Financial Partner”) to provide a significant percentage of the required equity capital for the project, oftentimes up to as much as 90%-95% of such required capital. The Developer will typically contribute the remaining and comparatively smaller portion of the equity capital and the balance of the funds needed to complete the project will be supplied by a third party construction lender.

The Developer and the Financial Partner will usually negotiate and enter into a joint venture agreement (“Joint Venture Agreement”) that sets forth the rights and responsibilities of the parties in a newly formed entity (“Owner”) that owns the real estate project. In a number of transactions, the Developer (or more typically an affiliate of the Developer) will also serve in a variety of capacities that might otherwise have been performed by unrelated third parties, such as general contractor, leasing agent and property manager. In these instances, the Developer and the Financial Partner will also negotiate a separate construction contract, leasing agreement and/or property management agreement, as the case may be.

Development transactions are typically regarded within the real estate investment community as higher risk investments than acquisitions of already developed projects. As such, investors in development projects will seek commensurately higher returns to compensate for the risk. Indeed, vast fortunes have been made and lost in the real estate development game. One of the key additional risks of development vis-a-vis acquisition, in addition to such risks as leasing, entitlement and environmental, is construction risk.

1 The role of Financial Partner on large scale projects is frequently carried out by pension funds, private equity funds, insurance companies, investment banks and high-net-worth individuals.
Construction risk may manifest itself in various ways, such as the project costing significantly more to complete than budgeted, being materially behind schedule, having patent and latent defects or simply not being constructed in the manner or with the specifications bargained for by the owner. Some of these risks (such as higher costs and delayed completion) will manifest themselves during the construction of the project, with consequent impact on the immediate economic arrangement between the Developer and the Financial Partner. Others, however, (such as defective work) may not become apparent until after the project is in use and may have a more indirect impact on financial performance by increasing operating costs, diminishing the long term value of the asset or generating third party liability (particularly in residential projects) to tenants or unit owners. The potential and complexity of these risks are often heightened in the not uncommon circumstance where the general contractor carrying out the construction is an affiliate of the Developer. This paper will explore the particular issues and conflicts inherent in circumstances where the Developer or an affiliate of the Developer serves as general contractor on the project and some of the steps a prudent Financial Partner should take to mitigate and address such conflicts.

Section 1 sets forth the nature of the conflicts. Section 2 outlines three common forms of construction contracts that provide the setting in which the conflicts often arise, namely lump sum (a “Lump Sum Contract”), cost of the work plus a fee (without a guaranteed maximum price) (a “Cost Plus Contract”) and a guaranteed maximum price (a “GMAX Contract”), and discusses the conflicts pertinent to each. Section 3 provides hypothetical illustrations that demonstrate the perils to the Financial Partner that may arise from the conflicts. Section 4 discusses some contractual and practical undertakings a prudent Financial Partner may wish to undertake to manage and mitigate the risks created by the conflict. Section 5 explains why, despite the perils inherent in the conflicted Developer/contractor arrangement, such arrangement nevertheless remains fairly common.

1. THE NATURE OF THE CONFLICT

As a general matter, the potential for conflict and lack of complete alignment will exist between any Owner of real estate and any service provider to such Owner. If a dispute arises, if a mistake is made, if the contract is ambiguous, or if other problems arise, the interests of the Owner and the service provider may diverge. In real estate projects where the Developer is, on the one hand, a part of the ownership and, on the other, the general contractor, the situation of divergent interests is compounded by the fact that the monitoring/gatekeeping role central to the development function falls outside of the traditional framework. Namely, it is not being carried out by an independent developer. One of the salient roles of the Developer is to ensure that the general contractor is performing its job. The Developer is tasked with managing the project and, central to that, to diligently protect the interests of the Owner and enforce the Owner’s rights under the construction contract. Unlike the typical Financial Partner, the Developer is expected to be highly expert in the often complex and highly specialized construction process. If the general contractor is the Developer itself or, more typically, an affiliate of the Developer, is it reasonable to expect that the Developer will faithfully protect the interests of, and fully inform, the Owner in the event of problems and conflict? In other words, is the proverbial fox watching the henhouse?

It is important to note that even if the Developer, as an entity, has a proper “long term” view of the project investment, the “project team” within the Developer’s construction affiliate may have different goals. It is not uncommon for construction companies to evaluate and reward project executives on the basis of the profitability for the construction company. In addition, the long term success of the construction affiliate
often depends on maintaining strong relationships with subcontractors and suppliers, whose economic fortune on a specific project is not connected to the overall investment return. These realities can result, especially in the “field”, in a misalignment of interests between the Developer and the Financial Partner, even when the overall investment relationship is healthy.

2. FORMS OF CONSTRUCTION CONTRACTS & ATTENDANT CONFLICTS
The practical manner in which conflicts may arise will often relate to the form of construction contract that is entered into. Three of the most common forms of construction contracts are: 1) the Lump Sum Contract, 2) the Cost Plus Contract, and 3) the GMAX Contract. Below is a description of each form of contract and the particular manner in which a conflict may arise.

Lump Sum Contracts:
In a Lump Sum Contract, the general contractor agrees that the project will be built for a fixed price. If the actual costs of completing the project are less than the fixed price, the contractor receives the entire difference as additional profit. If the costs of completing the project are more than the fixed price, subject to certain exceptions, the contractor will bear the cost. This is not an open book arrangement. Whether or not the contractor makes money under a lump sum contract is something that the owner will not know for certain as there is no transparency of costs. The advantage of this arrangement to the Owner is a relative certainty of cost. The advantage to the contractor is the potential for significant profit represented by the spread between the stipulated lump sum and the actual costs of completing the project.

The principal form of conflict in a Lump Sum Contract is in the negotiation of the fixed price. In a “normal” arrangement where the Developer is negotiating on behalf of the ownership with an unrelated general contractor, the Developer will be motivated to seek the lowest possible price. In addition, the Developer is often far better situated to underwrite the construction costs than the Financial Partner and determine what the likely actual cost of completing the project will be. In the situation where the Developer is also the general contractor, the Financial Partner will find itself dealing with a conflicted counter-party and likely at an informational disadvantage.

Cost Plus Contracts:
In a Cost Plus Contract, the general contractor will not guarantee the costs of completion of the project and is paid a fee (oftentimes based on a percentage of the costs of the project) for project coordination and execution. Generally speaking if the costs of the project exceed those anticipated for reasons unrelated to the fault of the contractor, the Owner will bear the costs. One advantage of this arrangement to the Owner is that if the actual cost of completing the project is less than expected, the Owner benefits from the cost savings. The advantage to the contractor of the arrangement is that it does not bear the risk of increased costs of the project.

The opportunity for conflict in this arrangement is somewhat less acute than in a Lump Sum Contract in that the contractor does not provide a guaranty of costs. However, the contractor will nevertheless be liable for mismanagement of the project per the terms of the applicable Cost Plus Contract. The Developer, tasked with monitoring the contractor,

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2 Even in a Lump Sum Contract there are certain instances, such as changes in scope, force majeure or changes in law, pursuant to which a contractor will not have to bear the cost.

3 A Developer may sometimes argue that because it is in the ownership and entitled to a “promote” if the project winds up successful, the Developer is incentivized to keep the fixed price of the general contract down. This assertion, however, cannot be correct as the Developer or its affiliate will receive 100% of any price increase under a fixed price scenario whereas it will always receive less than 100% of any savings through its ownership stake in the joint venture. The conflict inherent in negotiating the fixed price is a zero sum game.
will be conflicted in reporting incidences of mismanagement and enforcing the remedies of the Owner in such circumstances. Additionally, in many Cost Plus Contracts the fees of the contractor are set based on a percentage of costs, whatever such costs turn out to be. In this instance the Developer and contractor may have a financial incentive to raise the costs of the project unnecessarily (or at the very least an incentive not to fight subcontractors and suppliers to keep costs within an expected budgetary range if the long term consequence of such a dispute will be to damage the relationship between the subcontractor/supplier and the Developer’s construction affiliate).

**Guaranteed Maximum Price Contracts:**

In a GMAX Contract the benefits to the Owner of a Lump Sum Contract and a Cost Plus Agreement are combined. The contractor will be paid the actual cost of the work plus a fee, but will also guarantee to the Owner that the total costs to the Owner will not exceed a specified price, subject to certain exceptions. Accordingly, the Owner will benefit from any savings below an anticipated cost but will also enjoy the guaranty of a maximum price. In many GMAX Contracts the parties will negotiate a cost savings clause pursuant to which the general contractor will receive a percentage of the amount by which the actual cost of the project falls below the guaranteed maximum price set forth in the contract.

The principal conflicts in a GMAX Contract are 1) negotiation of the guaranteed maximum price, 2) negotiation of controls and limitations on the reimbursable “cost of the work” (particularly with respect to contractor-furnished items such as cost of contractor personnel, cost of contractor-owned equipment used for the project, costs of insurance, costs of bonds and costs for other overhead and “general conditions/general requirements” items), and 3) the resolution of open questions and disputes during the course of construction. In respect of negotiation of the guaranteed maximum price, the Developer, if affiliated with the contractor, may seek to make the guaranty number as high as it is able to limit the potential liability of its related entity. It will be incentivized to try to grant itself as much “cushion” as possible. The contractor may accomplish this by including an express contingency in the guaranty number, which if unused at the end of the construction is part of the shared savings. In this regard, if the GMAX Contract contains a cost sharing arrangement, the incentives to make that number as high as possible are even greater as the higher the point from which savings to share are calculated the greater obviously is the potential reward to the contractor/Developer. The second principal source of conflict involves the level of true financial transparency that will be available to the Financial Partner, and whether the Developer-affiliated contractor will have opportunities to realize “hidden profit” beyond the negotiated fee. The third principal source of conflict is the resolution of open questions and disputes during the course of construction, in relation to which the Financial Partner may not possess contractual rights with which to intervene and may oftentimes even lack knowledge of their existence.

The foregoing discussion relates principally to pricing and cost, which are the provisions that drive the differences in the forms of contract discussed. It should be noted that in all construction contracts a conflict will exist as to the negotiation and enforcement of other key and very important provisions, such as what happens if the project is completed behind schedule, how, when and if defective work is corrected, insurance coverage amounts and responsibilities for premium payments and deductibles, bonding or other performance guarantees, indemnities for third party accidents and liabilities, waivers or limitations of damages and numerous others.

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4 See footnote 2.
3: HYPOTHETICAL ILLUSTRATIONS & DISCUSSION

Construction projects of the type that involve large financial investors are complex undertakings with thousands of moving parts and details. A construction project will often have very extensive and complex construction drawings and plans prepared by the project architect (and frequently by additional and separately retained engineers for various disciplines) that a contractor must interpret, integrate and follow to complete the project. There will be numerous subcontractors whose efforts and schedules must be coordinated. There may be unforeseen site conditions, such as large rocks, unstable soil or undiscovered environmental contamination that may affect the timing and cost of the project in material ways. In other words, a construction project is a significant and complex undertaking where much can go wrong and often does. It would be impossible in the scope of this Article to fairly catalogue the near infinite circumstances and fact patterns in which a construction project may encounter difficulties and the manner in which the conflicted Developer arrangement may exacerbate such problems. However, some hypothetical fact patterns are provided below to illustrate the types of perils to the Financial Partner of both the construction process itself and the conflicted Developer arrangement.

Hypothetical #1: Student Housing Project

A financial institution invests 15 million dollars in equity capital in a project to construct a large apartment building that is adjacent to a university and will rent units to university students. The Developer will invest 1.5 million dollars and the remaining amounts needed in the $40 million dollar budget will be supplied by a third party construction lender. The investor was told that the project is on a tight time line. A GMAX Contract has already been signed between the Developer and its affiliated construction group. The business plan called for the apartment building to be completed by early July and at the latest early August, an ambitious but achievable schedule. In the event the project is not completed by August 1st, the contractor is subject to a delay payment of $1,000 dollars per day, as liquidated damages for the delay, per the terms of the GMAX Contract. The GMAX Contract also provides that if the building is completed for less than $40 million dollars, the contractor will share 50% of the cost savings. The building is completed in mid-September, 45 days late but at a total cost of $32 million dollars. The Owner missed the period when students rent apartments for the year and the building will remain largely vacant for such year, incurring taxes, utility costs and interest payments on the construction loan with little or no rent to pay for such costs. The construction contract provided that the contractor, upon direction of the Owner, would expedite the project through the use of overtime labor and weekend work. The development partner, who was administering the contract, did not elect to invoke such clause. The development partner claims that the project was delayed due to a combination of adverse weather conditions (20 rain days) and delays by the local building department to complete needed inspections and in neither case is the Owner entitled to compensation for its losses. The Financial Partner had been told by the Developer that it could expect to roughly double its investment in this student housing project. Due to the additional year of carrying costs and some adverse publicity regarding the failure of the project to open on time, the Financial Partner is now estimating that it will only make a slight profit on its investment, rather than doubling its money. Even if liable for the delay, the contractor would only incur $45,000 dollars in liquidated damages. Due to the cost-savings provision in the GMAX Contract, the contractor is awarded $4 million in additional fees as a bonus.
Hypothetical #2: Luxury Condominium Project

A Financial Partner invests in a project to construct an ultra-luxury condominium project in Manhattan. Many of the units are pre-sold to wealthy buyers who placed 20% of the purchase price on deposit and will pay the remaining 80% of the purchase price when the project is completed and delivered. Under New York law if the project is not completed within 12 months of the date set forth in the offering plan, buyers will have a right to rescind their contracts. Prior to the project being declared complete, New York experiences a number of heavy rainstorms. Significant amounts of water enter into the condominium units as a result of the storms and an engineer is hired to investigate. After two months of testing, the engineer concludes that the balconies were constructed or designed incorrectly and may need to be replaced in their entirety. After an additional three months of reviewing potentially less drastic alternatives with an additional engineering firm that specializes in water intrusion issues, it is concluded that the most prudent course of action is to in fact remove, redesign and replace the balconies. In addition to the substantial cost, removing and replacing the balconies will cause the period to be delayed more than one year from the date set forth in the offering plan. The prices of condominiums in this area of New York drops noticeably due to the economy and many buyers cancel or seek to renegotiate their contracts. The development partner claims that the balcony problem was a result of faulty design by the architect, which has limited professional liability insurance, and no amounts will be owing from the general contractor, which is an affiliate of the development partner. One of the engineering reports (which was not shared by the developer with the Financial Partner) indicated that although there were some design flaws attributable to the architect the main cause of the water intrusion stemmed from the contractor giving the concrete an inadequate period of time to cure, resulting in various cracks and pathways for water to pass through into the units. The additional interest on the construction loan during the delay period and the drop in sales proceeds will cause the value of the project to barely equal the construction loan balance and the Financial Partner’s investment in the project will be a complete loss. The contract, which was negotiated between the affiliated parties before the investment was made, contains a waiver of consequential damages (i.e., lost profits and interest carry) which inures to the benefit of the contractor and its insurer. The contractor entity is a special purpose entity formed for the individual transaction and has no assets.

Hypothetical #3: Oceanfront Resort

A Financial Partner invests in a project to construct a resort in an Oceanside community. An affiliate of the development partner is the general contractor. During the course of construction the Owner is notified of various increases in cost. One of those costs is a “change order” for doorknobs. The original plans and specifications called for doors but there was an omission for doorknobs which were not bid out and the Financial Partner is shocked that doorknobs were not somehow included in the original price. Moreover, additional costs were incurred when the contractor ordered the wrong sized windows. Because the windows could not be installed and needed to be re-ordered, other subcontractors could not do their work, such as insulation and flooring and were entitled to additional compensation for cancellations. Similar to Hypothetical #2, extensive leaking is discovered prior to the resort opening. It turns out that the plans called for a water-proofing membrane that did not self-seal when penetrated with nails, a sub-optimal choice for construction of this type. However, the construction documents
indicated that the contractor should not place nails through the membrane but this instruction was overlooked. To rectify the situation, the Developer hired another sub-contractor to coat the exterior of the building with a water-proofing gel. The cost of the gel was issued as a “change order.” In addition to the cost, the gel turned an opaque color after exposure to the sun, making the exterior of the resort unattractive. The development partner approved the increased cost without consulting the Financial Partner as the Joint Venture Agreement did not specify that the Financial Partner had the right to approve change orders.

The foregoing examples highlight a number of the key areas in which failure to adequately account for the Developer/contractor conflict can lead to financial loss to a Financial Partner in a real estate transaction. A discussion and by no means complete list of these key areas is set forth below.

1. Inadequate contractual protections. Construction contracts are susceptible to heavy negotiation and are often, as a matter of fact, heavily negotiated in large and important projects by sophisticated parties. The most sophisticated parties have learned and understand that how a construction contract is drafted can have a substantial impact on the ultimate economic results of a relationship to the parties oftentimes to a far greater extent than contracts in many other fields of commerce. The enormous variability of events within any given construction project places a great deal of importance on the contractual provisions that allocate the risk of such variability amongst the parties. As shown in Hypothetical #1, the contractor delivered the project late and claimed this was due to “adverse weather conditions.” While there may have been in fact strong rains during the construction period which stopped work on multiple days, was such weather typical for the region and something that should have been planned for and anticipated by the contractor? Was in fact the real cause of delay an oversight by the contractor in ordering supplies and the adverse weather a useful excuse? A more owner-favorable contract would have included the requirement that the adverse weather conditions be of an “unusual” extent or duration relative to the area in which the project is located. Many contracts will in fact specify a given number of rain or other adverse weather dates and will deem any amount of weather dates below that number as normal and not giving rise to a permissible delay. A more favorable contract might also have included a requirement to use the anticipated “savings” in costs to fund acceleration of the work to meet the leasing window or provide that any award of savings to the contractor would be contingent on the contractor delivering the project on time...In Hypothetical #2, the waiver of consequential damages in the construction contract (which may have appeared as relatively innocuous when it was negotiated) has left the entire JV with no meaningful insurance recovery. While some of the loss caused by the situation may have been covered by the contractor’s completed operations insurance, the contractual damage waiver is enforceable by the insurance carrier. Even a clause that waived consequential damages, except to the extent covered by insurance, would have given the JV an important potential remedy. If the Developer is controlling the contract negotiations with its affiliated contractor it is quite likely a contractor favorable contract will result, as it did in the hypothetical example.

2. Inadequate joint venture protections. In Hypothetical #1, there were delays also attributed to the failure of the building department to timely complete inspections. The construction contract may or may not have been breached in this instance depending on how it is written and whether there may have been
negligence on the part of the contractor in appropriately scheduling the relevant inspections and giving adequate advance notice. However, many Financial Partners believe that the risk of such matters as building department timing and sign-offs, and other such “development” risks, should be borne by the Developer. In addition, in one of the examples the Developer elected not to enforce a clause in the agreement to require the contractor to expedite the job through the use of overtime labor at its cost, and the Financial Partner had no right in the JV Agreement to require that the Developer do so.

3. Inadequate Plans. In hypothetical #3, the Owner was left without a remedy in relation to the fact that the plans provided for doors but did not provide for door knobs. This could have been addressed in the construction contract with language that included, within the scope of work, items that were “reasonably inferable” as necessary to provide “complete and functional” work.

4. Lack of information and field supervision. Among the most common sources of contention in construction failures is whether the particular failure was caused by the architect or the contractor. Many contractors will endeavor wherever possible to allocate blame to the project architect. If the Financial Partner does not have adequate access to information and field supervision rights, responsibility for project failures may be improperly avoided by the contractor. And, as noted earlier, the factual assessments as to these issues are being directed by the contractor’s field personnel, whose individual economic fortunes are tied to the profitability of their work, not the investment.

5. Lack of proper cost expertise. In Hypothetical #1, the GMAX Contract was likely too high and based on inflated cost projections. A better informed Financial Partner may not have agreed to such pricing.

4: RECOMMENDED UNDERTAKINGS

A prudent financial investor may undertake steps, such as the following, to mitigate the risks described above:

**Directly Review and Negotiate the Construction Contract and Hire Counsel with Specialized Expertise in Construction.**

In circumstances where the contractor is affiliated with the Developer, it is of paramount importance that the Financial Partner carefully review and negotiate the construction contract and should obviously do so with the assistance of counsel. In joint venture development transactions where the contractor is not affiliated with the Developer, many Financial Partners will rely on the experience and skills of the Developer to properly negotiate the construction contract and give the construction contract only limited review. In the conflict arrangement, the Financial Partner cannot rely on the Developer and must review and negotiate the contract as a central document of similar importance to the Joint Venture Agreement. Construction is a specialized field where a talented attorney may spend a lifetime practicing and still find much to learn. It is the opinion of the author that a Financial Partner in most circumstances should hire counsel whose practice and background is principally that of construction, even if that means hiring a law firm or lawyer that is unrelated to the lawyer or firm representing the Financial Partner on the joint venture and real estate aspects of the transaction. While a capable real estate generalist may competently protect the interests of the Financial Partner, in a high stakes development, counsel that devotes a substantial portion of their practice to the often highly technical field of construction is invariably a good choice.

**Obtain a Cost Overrun Guaranty from the Developer with Few Exclusions**
Sophisticated financial investors will frequently require that the Developer provide a cost overrun guaranty from the Developer in addition to having a well negotiated construction contract with the Developer’s affiliate. A cost overrun guaranty comes from the Developer and not the general contractor. The cost overrun guaranty seeks to transfer the “development risk” of the project to the Developer. Development risk includes a subset of circumstances that may not strictly be the fault of the Developer, but are simply inherent in undertaking a complex real estate project. The cost overrun guaranty essentially provides that the costs to build the project will not exceed a fixed number and if they do the Developer will pay for such costs out of its own funds. The principal difference between a well drafted cost overrun guaranty and a Lump Sum or GMAX Contract (both of which purport to set a fixed cap to the costs of a project) is that the cost overrun guaranty has very few exclusions to liability. A GMAX or Lump Sum Contract will nevertheless provide that if the architect makes a mistake, if there are unforeseen site conditions, if there is unusually bad weather and if a myriad of other circumstances arise, the price may go up and the cap exceeded. In a well drafted cost overrun guaranty, the only exclusions tend to be limited to such items as: 1) Owner-initiated or approved changes to the scope of the project, 2) true force majeure events, such as earthquakes, tornados and other natural disasters, and 3) changes in law enacted after the signing of the cost overrun guaranty. If a cost overrun guaranty is obtained, a number of the risks that arise by virtue of a poorly drafted or managed construction contract (e.g., architect errors) will be averted as the Developer will be required to cover such costs irrespective of the fact that the contractor would not be obligated to cover such costs under the construction contract. Some cost overrun guarantees will also include a “completion guaranty” providing that the project will be completed by a date certain. This also provides very important protection for the investor as the timing of completion of a project has important financial consequences.

A question may be asked: why would a Developer assume such significant liabilities under a cost overrun or completion guaranty? The answer is that in real estate development projects it is fairly common that the Developer will be entitled to receive a disproportionate share of the profits if the project goes well. The Developer also receives significant fees. Many Financial Partners take the position that assumption of the development risk in a project is the value that the Developer brings which entitles it to potentially substantial amounts of compensation above and beyond what the Financial Partner will receive on a pro rata basis. A Financial Partner will say that it will take “market risk” but that the Developer is being paid to assume “development risk.”

Reserve the Right in the Joint Venture Agreement to Unilaterally Enforce the Rights of Owner under the Construction Contract

The Financial Partner may wish to include provisions in the Joint Venture Agreement and the construction contract that permit the Financial Partner to unilaterally enforce the rights of the Owner under the terms of the construction contract. The necessity of such a provision may seem obvious but is often absent from Joint Venture Agreements. A clause of this type may be of importance in a multitude of circumstances. Take, for example, the

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5 A popular joke inside the construction industry is that a guaranteed maximum price contract is a guaranty of everything but maximum price.

6 A common drafting error made by Financial Partners in defining force majeure is to allow the inclusion of the catch phrase “and other causes beyond the Developer’s reasonable control.” This is an exception that largely “swallows the rule” in that it will leave it open for the Developer to argue that cost overruns should be excluded (i.e., borne by the Owner) to the extent they are attributable to mistakes by the architect, delays by government inspectors, unforeseen increases in the cost of supplies and virtually any other undesired circumstance not attributable to the Developer’s fault. If the only cost overruns for which the Developer is responsible are those of the Developer’s fault, the cost overrun guaranty has added little, if anything.
circumstance where a project is behind schedule due to the fault of the contractor. In such a circumstance the Financial Partner may seek to enforce a clause that requires the contractor to hire overtime labor or otherwise accelerate the work at the contractor’s expense. Or perhaps the contractor installed the wrong materials which need to be torn out and replaced. Or the Owner has a basis to sue the contractor for monetary damages. Or there is a need to call the contractor into default and potentially terminate the contract. If the Developer as a joint venture partner had the right to consent to any of these actions under the Joint Venture Agreement, this would obviously place the Financial Partner in an untenable position.

A sample joint venture provision that grants unilateral enforcement rights to the Financial Partner is set forth below:

Notwithstanding anything to the contrary, the [Financial Partner] shall have the right (but not the obligation) to unilaterally make any decision by the [Joint Venture] (as party to the contract or as the sole member of the [Joint Venture]) to exercise any right or remedy, to terminate, to extend, modify, amend or agree to a waiver or forbearance of, the [Developer-Affiliate Construction Contract]; however, nothing in this Section or elsewhere in the [Joint Venture Agreement] shall reduce the obligations of [the Developer Member] to enforce such [Developer-Affiliate Construction Contract] and to keep each [Member] informed of the status thereof (including any defaults thereunder and all facts relevant thereto) and of any rights that may be exercised thereunder.

Retain the Right to Approve Change Orders and Other Items under Construction Contract

The Financial Partner may wish to include provisions in the Joint Venture Agreement and the construction contract that require the Financial Partner’s approval for various items during construction, such as changes in the physical work, increases in the lump sum or guaranteed maximum price, extensions of time for completion, applications for payment, acceptance of the project as substantially complete and similar material items.

A sample joint venture provision that grants approval rights to the Financial Partner is set forth below:

[Developer Member] acknowledges and agrees as follows: (a) the [Developer-Affiliated Contractor] under the initial [Construction Contract] is an Affiliate of [Developer Member]; (b) [Developer Member] shall not accept the work under the [Construction Contract] as substantially complete or approve the punchlist without the prior written approval of [Financial Partner] in each instance; (c) all applications for payment (including the application for final payment) by the [Developer-Affiliated Contractor] shall be subject to the prior written approval of [Financial Partner], and the [Developer Member] shall neither approve nor make payments on any application for payment prior to written approval by the [Financial Partner]; (d) [Developer Member] shall not take any action or give any direction under the Construction Contract or with respect to the [Developer-Affiliated Contractor] without the prior written approval of [Financial Partner] if such action or direction would (1) change the scope of the work in any material respect, (2) increase the [Contract Time] or the [Contract Sum]/[Guaranteed Maximum Price] (as such terms are defined in the Construction Contract), (3) relieve the [Developer-Affiliated Contractor] of, or release the [Developer-Affiliated Contractor] from, any obligations or liabilities, (4) result in a reduction or early release of retainage, (5) result in a change in the previously approved schedule of values, (6) have the effect of approving the selection or award of any subcontract for
any portion of the work (and the [Financial Partner] shall have the right to approve
the award of each subcontract for any portion of the Work), or (7) allow the
[Developer-Affiliated Contractor] or an affiliate of the [Developer-Affiliated
Contractor] or the [Developer Member] to self-perform any portion of the work
which [Financial Partner] has not previously agreed in writing to allow;
(e) [Developer Member] shall not amend or modify the Contract Documents (as
defined in the [Construction Contract]), or settle any claim by or against the
[Developer-Affiliated Contractor] without the prior written consent of [Financial
Partner] in each instance; and (f) [Developer Member] shall deliver written notice
to [Developer-Affiliated Contractor] of all potential claims (whether for defective or
nonconforming work, personal injury, property damage, overpayment, liens, claims
from third parties, overpayment or otherwise) that the [Joint Venture] may have
against [Developer-Affiliated Contractor] in sufficient time, and containing
sufficient information, and otherwise take such other action as may be necessary or
desirable, to preserve such claims and prevent any such claims (and the rights of the
[Joint Venture] against the [Developer-Affiliated Contractor]) from being waived,
lost or otherwise impaired.

Hire Independent Cost Estimators and Construction Monitors
Most sophisticated Financial Partners will undertake an independent assessment of the
feasibility and reasonableness of the cost estimates for construction provided
by the Developer prior to committing to the transaction. This may be performed by an in-house
construction group or through the use of outside construction consultants. If the
construction budget is not reasonable or realistic, problems and controversy with the
Developer and general contractor are bound to ensue, irrespective of how strong and well
drafted the attendant legal documents may be. In all events, a Financial Partner is well
advised to ensure as a practical, non-legal matter that the construction budget and
ultimate contract price has been thoroughly vetted and found viable prior to moving
forward with the project. Many Financial Partners will also use internal staff or third
party monitors to track the progress of construction as it goes forward to catch early signs
of problems and be fluent in the details of the project to assist in timely and correct
decision making. Many Financial Partners will reserve the right in the Joint Venture
Agreement to have a member of its staff or a representative present in the on-site
construction office during the construction period, which right is of particular value in the
conflicted Developer/contractor arrangement.

5: CONCLUSION
If a structural conflict exists between a Financial Partner and a conflicted
Developer/general contractor and such conflict could result in potential financial harm,
why would any Financial Partner agree to it? There are at least two answers to this
question, both of which relate to the realities of the real estate equity finance and
development business. Financial Partners in real estate are in the business of providing
equity capital to Developers and seek to make a profit by so doing. Financial Partners
compete to do business with those whom they perceive to be the best and most capable
Developers with the best located real estate projects likely to yield the most significant
profits. Many of the Developers enter into the transactions in part for the related party
fees, including general contractor fees, and will choose only those Financial Partners that
will agree to have them serve as the general contractor or construction manager.\(^7\)
In other words, the arrangement “comes with the deal.” A second reason is that the Developer or
its affiliate may have an exceptional reputation as a general contractor for building

\(^7\) Many Developers started out in real estate as general contractors and only subsequently began to pursue
development.
quality projects on time and on budget and a Financial Partner may perceive that the value of this expertise and track record outweighs any downside arising from the structural conflict.

In either such event, the affiliated general contractor arrangement will persist as a fact of business in many real estate development projects. A prudent Financial Partner must approach any such development mindful of the conflicts inherent in such arrangement. Further, the prudent Financial Partner would be well advised to consider adopting the various undertakings outlined herein to help ensure a successful investment in the rewarding but complex real estate development sector.8

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8 The author would like to thank Bruce Tribush of Goodwin Procter LLP and Joseph Colagiovanni of Baker Botts LLP, two exceptionally fine attorneys in the construction field, and Stevens Carey of Pircher, Nichols & Meeks, an exceptionally fine real estate and joint venture counsel, for their kind and thoughtful comments to this Article.