COST OVERRUN PROVISIONS IN REAL ESTATE JOINT VENTURE AGREEMENTS

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Real estate investments often involve construction (Project), such as ground-up development, renovation, or tenant improvements, and a heavily negotiated issue in a joint venture relationship is how and to what extent Project cost overruns are allocated. This article provides a brief overview of some of the issues that arise when determining allocation of responsibility for Project cost overruns where a Project is owned by a joint venture (the JV) that is: (i) between a majority investor (Investor Member), with a capital interest of 90 percent or more, and an operator/developer (Operator Member), with a capital interest of 10 percent or less (collectively, the Members); and (ii) is governed by a joint venture agreement (the JV Agreement).

WHAT ARE COST OVERRUNS?

Put simply, for purposes of a JV, a cost overrun occurs when the construction costs (or a particular category of construction costs) exceed the budget (or the line item of the budget intended to cover a particular category of construction costs) approved by the Members. But there are many variations. Thoughtful consideration may be required to determine the appropriate treatment, both in terms of initial payment responsibility and potential reimbursement, of a cost overrun, depending upon, among other matters, the type and cause of the relevant cost.

Interplay with the GMP construction contract

One may wonder why the problem of cost overruns is not solved by entering into a "GMP" (i.e., guaranteed maximum price) construction contract with a general contractor. Won't the general contractor pay for all the cost overruns? The short answer is no.

There are many costs that may not be the responsibility of the general contractor. For example, most GMP construction contracts contain certain specified exceptions to the GMP (e.g., for differing site conditions or changed conditions) and provide for "allowances" for certain line items (e.g., countertops), which function as mere estimates because the owner has not yet made a decision (so that actual amounts may be more or less than the allowance and the decision is not subject to the GMP). It should also be noted that the GMP only covers the cost of construction, and what that includes is a point of negotiation.

Some development costs simply may not be expected to be paid by a general contractor (e.g., fees of design professionals, property taxes, utilities, insurance, debt service, permits, and leasing costs—sometimes until completion and sometimes until stabilization) and therefore not part of the GMP even though they can result in a bust of the overall JV budget. Some costs that Members might assume are in the GMP are not, or were negotiated not to be, with that change in terms not being made clear to everyone involved. In addition, the GMP construction contract typically includes requirements for the JV to have certain types of insurance that will be a Project cost not reflected in the GMP. Further, the GMP will often be increased based on changes required by review and inspection by the authority having jurisdiction over the work, normally a building safety department. And, of course, there is always the possibility that the general contractor might breach its obligations or not have the wherewithal to fund its share of the overruns, resulting in even more overruns for the JV.

For all of these reasons and more, the Members in a JV cannot solely rely on the general contractor to pay for cost overruns pursuant to the GMP construction contract.

Determination of cost overruns

There are different ways to determine cost overruns in a JV Agreement: (i) line item versus aggregate basis; (ii) forward versus backward looking test; (iii) contingency and line item savings; (iv) original budget; and (v) balancing calls.

Cost overruns may be determined on a line item basis (with reference to each line item category) or on an aggregate basis. The Investor Member typically prefers a line item determination—especially for large construction projects—so it can keep closer tabs on the deviations between budgeted and actual costs. This approach serves as an early warning system alerting the Investor Member that the Project may require "value engineering" or that it may be advisable to obtain some security from the Operator Member to secure its likely overrun obligation.

Cost overruns may also be determined either based only on the costs incurred to date (a backward looking test), or based on both the costs incurred to date plus the costs reasonably anticipated to be incurred (a forward looking test). For example, assuming cost overruns are determined on a line item basis, if only 20 percent of a particular category of the work has been completed but 60 percent of the budget line item applicable to that category of the work has been spent, then there would be an overrun under a forward looking test (to the extent the projected remaining cost to complete the particular category of the work exceeds the unspent portion of the budget line item for such work). But, with a backward looking test, there would be no line item overrun until the full amount of the line item has been expended.

In the battle against avoiding cost overruns being funded by the JV or its Members, the first line of defense is the GMP construction contract (but as discussed above, there may be many reasons why the general contractor is not responsible for the cost overrun). The next lines of defense are: (i) the contingency line item or items (often, if not usually, there are separate contingency line items for hard costs and soft costs); and (ii) if cost overruns are determined on a line item basis, line item savings. Many JV agreements will indicate that a cost overrun does not exist to the extent it is covered by contingency or line item savings. For simplicity, we will assume that any line item savings are added to the applicable contingency line item so that we can focus on contingency without referencing line item savings.[1]

In all events, cost overruns should be determined and measured by reference to the originally approved budget, subject only to budget amendments to reflect truly discretionary changes in the scope of the Project.

The Investor Member will typically insist that any balancing calls by the construction lender be treated as cost overruns and funded by the Operator Member (subject to final reconciliation upon completion of the Project).

ALLOCATING RESPONSIBILITY FOR DIFFERENT KINDS OF COST OVERRUNS

Knee-jerk positions

The Operator Member may be looking to the Investor Member (which typically has the deeper pockets) to cover unexpected costs, because the Operator Member may not have money for costs it cannot control and because it may have already made a meaningful equity contribution at the insistence of the Investor Member (so-called "skin in the game").

By contrast, the Investor Member is likely to argue that the Operator Member's greater familiarity with the Project and the local market, its hands-on experience in project design, cost-estimating, and project management, and its day-to-day control over the Project put it in a better position to anticipate and protect against cost overruns. Further, the Investor Member may take the position that the Operator Member should bear the risk of cost overruns regardless of whether they could have reasonably been anticipated or were within the control of the Operator Member as a pure allocation of risk (regardless of fault or causation). The justification typically articulated by the Investor Member to support this risk allocation is that the Operator Member should take a disproportionate share of the downside in exchange for the disproportionate share of the upside it is getting through the "promote" (i.e., an extra share of profits after the Members have received a return of their capital and a specified return on such capital).

Cost overruns shared by percentage interests

Even if the Investor Member's position generally prevails, the Investor Member may be willing to treat certain cost overruns differently, as costs to be borne by the JV. For example, the Investor Member may be willing to share with the Operator Member, in accordance with the Members' respective JV percentages (or potentially some other sharing formula): (i) cost overruns attributable to a *discretionary* scope change mutually approved by the Members, as distinguished from a *required* scope change, (e.g., a change in laws that was neither foreseen nor reasonably foreseeable by an experienced developer); (ii) increases in real estate taxes, utility rates, or insurance premiums (provided such increased taxes, utility costs, and insurance costs do not result from unexcused Project delays); (iii) increases in interest costs due to unhedged rate increases in variable rate financing (as opposed to unexcused Project delays); (iv) environmental remediation; and (v) leasing costs. In the authors' experience, the Investor Member is often reluctant to share additional costs of carrying the Project by reason of construction delays, the responsibility for which may depend on other factors described below.

Fault cost overruns

The least controversial overruns for which the Investor Member typically wants the Operator Member to take responsibility (by indemnity or otherwise) are those which the Investor Member assumes should be the responsibility of the Operator Member or its affiliates by reason of the Operator Member's general duties as the managing or administrative member of the JV or its affiliates' obligations under any construction or project management agreements (Fault Cost Overruns).

The Operator Member is often responsible for all costs (not just overruns) caused by: (i) breaches of the JV Agreement or certain affiliate agreements (e.g., where an affiliate of the Operator Member has entered into a construction or construction management agreement with the JV); or (ii) "bad conduct" (which may be defined in several ways, but may include gross negligence, willful misconduct, fraud, intentional misrepresentation, misappropriation of material assets, knowing violation of law, or certain criminal conduct) by the Operator Member or its affiliates. If so, it follows that the Operator Member would be responsible for cost overruns attributable to such causes.

The Investor Member also may want the Operator Member to be responsible for cost increases that are: (i) within the reasonable control of the Operator Member (to avoid); or (ii) that are reasonably foreseeable at the time of the original budget (and therefore should have been addressed in the budget). There is obviously overlap between the overruns described in this paragraph and the prior paragraph. Some investors argue that they should both fall into a single bucket. The Investor Member may expect the Operator Member to avoid overruns in these two paragraphs as part of its duties and to be solely responsible for any such overruns that occur as a result of the Operator Member's failure to avoid them.

Some investors may want to expand this single bucket if an affiliate of the Operator Member is acting as the general contractor and is terminated for cause. In that event, the Investor Member may want the Operator Member to be solely responsible for the costs to remove and replace the general contractor.

No-fault cost overruns

The cost overruns as to which allocation of responsibility is most heavily negotiated are those that are not discretionary, not foreseeable, not within the reasonable control of the Operator Member, and not attributable to a breach or bad conduct (No-Fault Cost Overruns).

As stated earlier, the Operator Member may be hard-pressed to bear the economic burden of these additional costs. While it may be in a better position to evaluate the risk, it may not have the money to fund the costs. However, the Investor Member may believe that taking responsibility for certain No-Fault Cost Overruns is simply an allocation of risk and part of the quid pro quo for getting a disproportionate share of the upside in the form of a promote.

While the Investor Member may feel that allowing any exceptions to the Operator Member's overrun responsibility can result in a difficult line-drawing exercise or so-called "slippery slope," compromises are often made. For example, certain overruns are often excluded based on the type of cost involved (e.g., discretionary scope changes mutually approved by the Members). In addition, overruns are sometimes excluded to the extent they were caused by specific, limited force majeure events, such as the following: (i) natural catastrophes (e.g., earthquakes or hurricanes); (ii) cataclysmic events (e.g., terrorist acts or war); (iii) atypical delays in getting permits due to a government shutdown; (iv) labor disputes (e.g., strikes) not specific to the Project; and (v) governmental action (e.g., building moratoriums or changes in law or interpretation of existing law). However, the Investor Member may want to qualify these exceptions by requiring that: (i) the overrun is not unique to the Project, reasonably foreseeable, or within the Operator Member's control to avoid; and (ii) written notice be given to the Investor Member and the Project lender within a short period of time following the occurrence or onset of the force majeure event.

Unforeseen soil conditions can be a hotly contested issue because the associated costs may be significant. Where the line is drawn for all these exceptions varies from deal to deal and can be the subject of extensive negotiation.

The negotiation described above may leave the Members with two categories of No-Fault Cost

Overruns: (i) those No-Fault Cost Overruns for which the Operator Member is 100 percent responsible (Guaranteed No-Fault Cost Overruns); and (ii) those No-Fault Cost Overruns for which the Members share responsibility (Non-Guaranteed No-Fault Cost Overruns).

Limitations

Where the Investor Member does agree to some sharing of responsibility for funding Non-Guaranteed No-Fault Cost Overruns, it may require sharing in some ratio other than percentage interests. For example, if the Investor Member's percentage interest in the JV is 90 percent and the Operator Member's is 10 percent, the Investor Member might require that Non-Guaranteed No-Fault Cost Overruns be shared 50/50. This could relieve some pressure on the Operator Member's finances, while at the same time incentivizing the Operator Member to be vigilant in managing costs.

The Operator Member may try to have its exposure for disproportionate sharing of No-Fault Cost Overruns limited by, for example, having a hard cap at some dollar amount or having one or more limits beyond which the Operator Member's share of overruns decreases.

Use of contingency

Should the Operator Member be able to use contingency line items to cover what would otherwise be No-Fault Cost Overruns? The Investor Member may seek to impose some limits on the use of the contingency. There are often controls on when and how contingency may be used. For example:

- Sometimes the Investor Member's approval is required after a certain percentage of the contingency has been used;
- Sometimes the Investor Member's approval is required unless the percentage of the contingency that has been used does not exceed the percentage of completion (and sometimes this percentage is grossed up to preserve the ratio of the remaining contingency to the total remaining budget so that, for example, if there were a five percent hard cost contingency, the remaining contingency is never less than five percent of the remaining projected hard costs); and
- Sometimes the soft cost contingency and hard cost contingency are separate and savings in one may not be allocated to the other without the Investor Member's approval.

An often-overlooked issue is how the contingency should be allocated between the Guaranteed No-Fault Cost Overruns and the Non-Guaranteed No-Fault Cost Overruns. The Operator Member would of course want to make the contingency be available primarily to pay the Guaranteed No-Fault Cost Overruns. Not surprisingly, the Investor Member may have the opposite view. It may want to limit the use of contingency to Non-Guaranteed No-Fault Cost Overruns, with the Operating Member covering Guaranteed No-Fault Cost Overruns without the use of contingency.

RETURN OF AND RETURN ON COST OVERRUN FUNDINGS

The Operator Member that funds cost overruns may seek to recover the money funded. Many investors are willing to accommodate this request but may want limits. For example, if cost overruns are determined on a line item basis, then the Operator Member is typically allowed to recoup the Guaranteed No-Fault Cost Overruns it funds from aggregate construction budget savings. Sometimes the Investor Member will agree to let the Operator Member recoup its No-Fault Cost Overruns somewhere in the distribution waterfall, but will often want a cap, no interest or return on the amounts recouped, and subordination to a certain threshold returned to the Members (e.g., a minimum IRR). However, Non-Guaranteed No-Fault Cost Overruns may sometimes be returned to the Members as a priority with a higher return.

In any event, the Investor Member is likely to resist allowing the Operator Member to get any credit (whether capital account or contribution credit) or reimbursement for Fault Cost Overruns. Unsurprisingly, investors and operators do not always see eye to eye on this allocation. Some operators take the position that they should be entitled to credit and reimbursement for any Fault Cost Overruns paid by them to the extent not caused by their (or their affiliates') breach or bad conduct.

BACKSTOP BY AFFILIATE OF OPERATING MEMBER

Another consideration is the likelihood the Operating Member will have the capability to fund cost overruns for which it is responsible. Since the Members are typically single purpose entities, the Investor Member may require that a creditworthy affiliate or affiliates of the Operator Member sign a separate guaranty (which may be in the form of a joinder to the JV agreement) or other backstop of the Operator Member's overrun obligations.

OVERRUNS EXCLUDED FROM COST-BASED FEES

The Investor Member will often require that cost overruns be excluded in the calculation of cost-based fees payable to the Operator Member or its affiliates. For example, if there is a construction management fee equal to X percent of certain hard and soft costs, then cost overruns (among other costs) may be excluded in the calculation of the fee.

CONCLUSION

Well-drafted cost overrun provisions in a JV Agreement will help prepare the Members to deal with unexpected overruns in a timely manner, without the delay of arguing about which Member should be responsible and to what, if any, reimbursement or credit the funding Member should be entitled.

Notes

1 There is sometimes a negotiation over whether and when line item savings may be established and, in particular, whether they can be recognized before final completion of the Project and payment for the applicable line item. But that subject is beyond the scope of this article.