Avoiding investor pitfalls in complex construction financing arrangements

Construction constantly becomes more complex, in engineering and organisation and legal aspects. **Lawrence Winsor**, Counsel, of **Vinson & Elkins**' Houston office, says project financing is increasing in complexity as well. Some simple tactics can help avoid pitfalls and disputes.

The frontier for construction project investment continues to grow – not just geographically and technologically – but also structurally, in the legal sense. Both equity and debt investors can employ a variety of complex corporate structures, project delivery methods, and financial realization plans to maximize return. Despite well-drafted and well-intentioned agreements, these complex arrangements often lead to disputes when economic expectations falter.

This article highlights some of the recurring pitfalls observed for investors in complex construction project financing, and offers simple tactics to help avoid the issues and related disputes. These considerations apply to a broad range of construction projects, including energy, power, petrochemical, transportation, logistics facilities, and manufacturing facilities.

Substituting Corporate Organization Agreements or Joint Venture Agreements for Construction Contracts

Complex construction financings may involve organization of a joint venture as a Limited Liability Company ("LLC") or similar entity. A common arrangement joins both sponsors and construction contractors as LLC members to share in both the project construction risk and expected financial reward. The members may assign complete project completion responsibility to the construction contractor, effectively creating a turnkey Engineering, Procurement, and Construction ("EPC") agreement within the LLC organization documents. However, the organization agreement will not contain the extensive terms found in an EPC agreement, including technical specifications, schedule milestones, liquidated damages provisions, and termination provisions. A construction dispute between members will then necessarily manifest as a partnership dispute, perhaps even in Delaware Chancery Court depending on the state of incorporation.

Joint venture agreements with a construction contractor may also include multi-project guarantees or Rights of First Refusal for projects to, for example, incent the contractor to purchase specialized equipment. In the event that the contractor performs poorly – including on matters of health and safety – these guarantees impede termination of the contractor.

To avoid these disputes, members should require the LLC and construction contractor to enter into a complete, formal EPC agreement outside of the organization documents, with standard termination provisions, delivery delay penalties, and dispute resolution clauses. The sponsor member should maintain sufficient rights and power to bring suit against the construction contractor and to refuse to further work with the construction contractor when cause so exists.

Unsecured Creditor without Sufficient Recourse

Long-term purchase and sales contracts including a funding mechanism for new construction also create hazards for investors without formal construction and security agreements. Industrial purchasers seeking to incentivize construction of a production facility – such as a chemical feedstock or power plant – may provide an upfront payment to cover part or all of the construction costs in exchange for a long-term reduced purchase price or preferential access to the output. In this circumstance, the purchaser becomes an unsecured creditor in the absence of formal security agreements and procedures. The purchaser also has no authority to influence construction decisions should the project faulter. Purchasers should instead formalize lending agreements with the rights to take over the construction project should the seller default – including rights to proceeds of construction bonds in order to ensure project completion.

Inconsistent Project Completion Expectations

Private equity sponsors may face a mismatch between exit or realization targets and the realities of completing a project. This problem often manifests in the common situation where private equity sponsors raise funds before (or while simultaneously) pursuing projects to deploy the capital. Fundraisers may set exit targets in investor materials that are ultimately inconsistent with the realities of the construction process. The economic expectations of a private equity investments may be more time-sensitive than traditional investments, particularly if the sponsor plans to exit the project through a sale instead of long-term operation of the project.

A related occurrence is when a project falls behind schedule expectations. The sponsor may give a directive to a contractor to "get this done as quickly as possible." If the contractor spends additional money to comply with the directive, the order may be construed as a directive to accelerate, and may lead to acceleration claims by the contractor against the sponsors.

Project selection, planning, and management are key to avoiding these disputes. First, sponsors should not enter into projects with unrealistic or tight completion schedules, including schedules with insufficient float or contingencies. While sponsors may face time pressure to deploy capital, the pressures will only amplify if promised returns to investors are late due to project delays. Second, sponsors should pay close attention to the project completion schedule and the contractor's means and methods proposals to ensure the schedule is realistic. The corollary is that the lowest bid price may not provide the best or most reliable project delivery schedule. Third, sponsors should negotiate definite, unambiguous project delivery deadlines with requisite penalties for misses.

Reluctance to Notice Default to Contractor

Sponsors may be reluctant to notice default to a construction contractor, as this may trigger an obligation to alert the sponsor's clients that the project faces difficulties, effectively conceding that the investment may not meet economic expectations. Courts require strict compliance with default, termination, and construction bond conditions, and project sponsors should not expect a court to provide equitable relief from strict compliance even if the contractor is a bad actor. Delaying notice to a poorly performing contractor only increases challenges should the project enter litigation.

Local Regulation and Challenges

International and regional investments pose unique costs and risks. When entering a foreign market, project sponsors must consider permitting requirements (and bureaucratic delays), tax structure, import duties, and import restrictions. Particular attention must be paid to labour. Productivity expectations, union requirements, local regulation, holidays, and work stoppages greatly impact schedule viability and progression. Engaging local counsel, agents, planners, and engineers will support more realistic cost projections and schedule expectations.

Insurance

Although some states may provide liability protection to a sponsor, a wholly owned operating company will not be shielded. Construction sponsors should ensure sufficient liability insurance for the project. The policy should protect all exposed entities in the organizational structure.

Investors should also oversee the terms of construction bonds. The bond terms should give the investors a right to call construction bonds in the event of contractor insolvency or malfeasance. Performance bonds should also comply with respective state statues to prevent liens on the property by unpaid contractors or sub-contractors.

Conclusion

Complex construction financing arrangements present potential pitfalls and risks; but these can be eliminated or mitigated through robust formal construction agreements, corporate structure, project planning, and project execution oversight. **CL**