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Navigating Tariff Risk in Construction and Development Deals

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Tariff Policy Shifts Introduce New Real Estate Risks

Over the past few months, there have been significant changes to tariffs by the United States and other countries around the world. These changes continue to evolve and there is significant uncertainty about the timing, rate, and overall impact of tariffs. The magnitude of uncertainty and cost associated with tariffs has resulted in new and increased risks to existing and prospective real estate projects. We see this broken down into the following questions from clients:

- How are these new costs covered under our existing agreements?
- How do we address the risks of these potential new costs in the agreements that we are currently negotiating?

Where to Look: Construction and Partnership Agreements

In real estate, answers to these questions are most likely to be found in the construction contract between the owner and the general contractor and the partnership agreement(s) (i.e., operating or joint venture agreement) among sponsors and investors in the project.

Reviewing Key Construction Contract Provisions

As an initial step to clarifying these questions, we recommend reviewing the provisions in your construction contracts which govern the allocation of risk and costs with respect to compliance with changes in the law, force majeure (also known as, third-party delays), and tax and tariff responsibility (Sections 3.7, 8.8 and 3.6 in the form AIA 201-2017, respectively). While the standard AIA form is silent, some parties may have negotiated these terms to clarify whether the contractor or the owner is responsible for the costs associated with newly enacted tariffs. We are already seeing general contractors proposing new provisions that expressly place the risks associated with increased costs from tariffs on the owner. In these circumstances, at a minimum, those increased costs should be passed through without any additional fees or general conditions costs and, generally speaking, there is no reason for these increased costs to result in schedule delays (unlike traditional force majeure events).

Impact on Ownership Structure and Cost Sharing

When the owner is responsible for increased costs from tariffs, the next question to ask is how those costs are allocated among the ownership parties; and whether the developer or sponsor of a project is obligated to incur all or a disproportionate share of such costs. In many circumstances, the operating agreement governing the relationship among the partners should determine how cost overruns are to be shared and whether there is any overriding force majeure clause that applies to the situation. The traditional concept of force majeure, as interpreted by the courts, is limited to “acts of God” and the like, and is unlikely to cover changes to tariffs. However, force majeure clauses are often heavily-negotiated in development joint ventures and may include concepts such as “changes in law” that, when read closely, encompass the costs associated with the changes in tariff policy. Additional questions to ask are:

- In what proportion are those costs allocated among the partners;
- What discretion does the developer have to apply contingency or other cost savings to cover these costs; and
- What approvals are needed to adjust the development budget to reflect these costs (including through change orders to the construction contract).

Mitigating Risks Through Careful Legal Review

As clients brace for the impact from these ongoing policy changes, we encourage you to consult with legal counsel to familiarize yourself with your rights, obligations and risks with respect to newly-imposed tariffs. In these unprecedented times, attorneys can provide tailored advice to address your specific circumstances to mitigate exposure to increased project costs and schedule impacts. This can only be done through careful analysis and negotiation of your transactional documents.

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