JOINT VENTURE DEVELOPMENT ISSUES

J. Cary Barton

745 E. Mulberry Avenue, Suite #550
San Antonio, Texas 78212
BartonBensonJones.com
210.610.5335 • info@BartonBensonJones.com

DISCLAIMER: Barton Benson Jones presents the materials on this web site for informational purposes only. These materials do not constitute legal advice and are not a substitute for legal advice from qualified counsel. Moreover, due to the rapidly changing nature of the law and our reliance on information provided by outside sources, we make no warranty or guarantee concerning the accuracy or reliability of the content of this document or any other referenced documents. If you require legal advice, you may contact an attorney at Barton Benson Jones PLLC.

© 2020 by Cary Barton

J. Cary Barton is a graduate of Baylor University (B.A. 1962) and Harvard Law School (LL.B. 1965) and was admitted to the State Bar of Texas in 1965.

He worked for the Federal Power Commission and the U.S. Tax Court in Washington, D.C., following his graduation from law school. He served in the United States Air Force during the U.S.S. Pueblo crisis in Korea, including a year during which he was stationed at Osan AFB, Republic of Korea. He has been engaged in the private practice of law in Texas since 1969, consisting of six (6) years in Corpus Christi, 13 years in Austin and the period since 1988 in San Antonio.

He is currently the senior member of Barton, East & Caldwell, P.L.L.C., a thirteen-lawyer firm in San Antonio, Texas, that was founded in 1993. He is Board Certified in Commercial Real Estate Law by the Texas Board of Legal Specialization and his law practice consists primarily of representing real estate developers and investors in commercial real estate transactions.

Mr. Barton is a fellow of the American College of Real Estate Lawyers. He has been a member of the Real Estate Forms Committee of the State Bar of Texas since 1986. He served two four-year terms as a member of the Council of the Real Estate, Probate and Trust Law Section of the State Bar of Texas and a three-year term as a member of the Commission of the Texas Board of Legal Specialization that administers the annual examinations for board certification of real estate legal assistants. He is a Sustaining Life Member of the Texas Bar Foundation.

Texas Lawyer named Mr. Barton as one of five finalists for the first and second "Go To" Texas Real Estate Attorney awards for 2007 and 2012. He was selected as a Texas Super Lawyer in 2003-2014 by Texas Monthly and Law & Politics Magazine, including recognition as one of the Top 50 Lawyers in Central and South Texas in 2006-2007, one of the Top 50 Lawyers in Central and West Texas in 2009-2012 and one of the Top 100 Texas Super Lawyers in 2007. He was listed as one of San Antonio's Best Attorneys in Scene in SA Monthly in 2004-2014.

Mr. Barton received the fourth annual lifetime achievement award for contributions by a distinguished Texas real estate lawyer from the Real Estate, Probate and Trust Law Section of the State Bar of Texas in 2003.

He received the Best Speaker Award for the 2004 Advanced Real Estate Law Course of the State Bar of Texas for his presentation entitled "Feasibility Issues/Can I Do the Deal?"

He was one of four Texas lawyers granted a Standing Ovation award in 2009 for his contributions to continuing legal education programs sponsored by the State Bar of Texas.

He received the Ralph A. Mock Award from Texas Lawyers Concerned for Lawyers in 2009 in recognition of his assistance to impaired lawyers in Texas and was the 2012-2013 president of that organization.

He received the TexasBarCLE Weatherbie Workhorse Award at the 2010 Advanced Real Estate Law Course of the State Bar of Texas.

He is the editor of Texas Practice Guide: Business Entities, Volumes 1-4 (Thomson-Reuters, 2014).

He is a member of the Founders Council of the Real Estate Finance and Development Department of the School of Business of the University of Texas at San Antonio and of the Real Estate Council of San Antonio. He has recently served on the Relocation Committees for the San Antonio Children's Museum and Dress for Success – San Antonio.

He was listed in The Best Lawyers in America (Real Estate) (1987-1988 and 1997-2014) Woodward White; and named The Best Lawyers in America Lawyer of the Year in real estate in San Antonio (2014) Woodward White.

He was selected as one of two Outstanding San Antonio Real Estate Lawyers, San Antonio Business Journal (2012).

TABLE OF CONTENTS

I. INTRODUCTION 1

II. FINANCING NEW MULTI-FAMILY PROJECTS 1
- A. Availability of Financing 1
  - 1. General Considerations 1
  - 2. Availability of Debt Financing 1
  - 3. Availability of Equity Financing 1
- B. Terms of Debt Financing 2
  - 1. Term of Loan 2
  - 2. Cost of Debt Financing 2
  - 3. Guaranties Required for Debt Financing 2
  - 4. Required Debt to Equity Ratio 4
  - 5. Transferability Issues 4
- C. Terms of Equity Financing 4
  - 1. General Considerations 4
  - 2. Initial Equity Contributions 4
  - 3. Obligations for Cost Overruns 5
  - 4. Preferred Return on Equity Contributions. 6
  - 5. Residual Distributions. 6
  - 6. Allocations of Profits and Losses 7
  - 7. Distributions 8
  - 8. Development Fee 9
  - 9. General Contractor's Fee 10
  - 10. Property Management Fees and Leasing Commissions 10
  - 11. Condominium Conversion Restriction. 10
  - 12. Exit Strategies 10
  - 13. Recent Case on Fiduciary Duty 10
  - 14. Sample Joint Venture Agreement – Appendix A 11

III. CONCLUSION 11

APPENDIX 13

JOINT VENTURE DEVELOPMENT ISSUES

I. INTRODUCTION

This presentation endeavors to describe some of the more important issues that a lawyer may commonly encounter in negotiating and documenting joint venture agreements for new multi-family projects in Texas. The author's interest in this topic began more than 35 years ago. See, Barton and Morrison, Equity Participation Arrangements between Institutional Lenders and Real Estate Developers, *Symposium – Real Estate Finance – An Emphasis on Texas Law*, St. Mary's Law Journal, Volume 12, No. 4, pages 929-1025 (1980-1981). It has continued to be a significant component of the author's legal practice since that time.

The reader should be aware that the author represents real estate developers almost exclusively. Accordingly, although no disrespect is intended toward our colleagues who represent investors and lenders, or their clients, the author's views of some of the issues discussed in the following pages almost certainly reflect the perspective from the side of the table where the author usually sits.

II. FINANCING NEW MULTI-FAMILY PROJECTS

A. Availability of Financing

1. General Considerations

Assume that a developer has determined that there is a need for a proposed new apartment project in the relevant market area and, if appropriate, that there will be a market for selling the project when it is completed. Also assume that the developer has determined that it will be feasible to obtain the necessary entitlements for the contemplated project. The developer then has to analyze the other threshold issue of whether financing is available for the development and construction of the new project. Although the determination of a market-driven need for the project would seem to render the availability of suitable financing a foregone conclusion, that is not necessarily the case.

2. Availability of Debt Financing

The major component of financing for the development and construction of a new real estate project is customarily debt financing provided by a bank or similar financial institution. In some prior periods of time, lenders would not provide financing for particular types of projects or would not provide financing in particular geographical areas. During the period from the mid-1990's through 2008, however, subject to some exceptions, the amount of financing which was available seemed to exceed the demand for financing for good quality projects of most product types in most geographical areas.

The housing bust of late 2008, the collapse of Lehman Brothers and disintegration of the CMBS financing market and related unemployment and financial uncertainties virtually eliminated financing for commercial real estate projects until the third quarter of 2010. The financing climate has been improving since that time, but the improvement is very focused by product type and location and financing may be more difficult to obtain for some types of real estate than others.

Although financing for the development of hotels, office buildings, retail projects or industrial properties is not impossible to obtain, such availability would appear to be somewhat limited and highly dependent upon special circumstances, such as exceptional location, high percentage of pre-leasing or occupancy, involvement of highly reputable sponsors and excellent credit-worthiness of the guarantors of the financing.

On the other hand, both construction and equity financing seem to be fairly readily available for well-planned and well-sponsored new multi-family projects. There have been reports of as many as a half-dozen construction lenders bidding to finance an individual new multi-family project. The market for selling new multi-family projects after they are completed also seems to be robust.

In some instances, debt financing may be available for real estate projects from various governmental or quasi-governmental sources. Although those lenders are sources of significant amounts of financing, and some information about programs of this type is set forth below, an analysis of the requirements and benefits of those programs is beyond the scope of this presentation. An enterprising developer, however, will be well advised by the developer's legal counsel to engage a mortgage broker who is knowledgeable about such programs to determine if they represent a feasible source of financing for a contemplated project.

3. Availability of Equity Financing

Equity financing for real estate projects can be obtained from institutions or private investors either in the form of traditional equity capital contributions or in the form of mezzanine financing which is nominally non-recourse debt and is secured by the ownership interests in the entity which owns the real estate project, without any subordinate liens on the real property itself.

Discussed below are some of the specific issues that will need to be resolved in negotiating the terms of equity financing for a particular real estate project. Such financing is generally readily available at this time for well-located and well-designed multi-family projects, although it may not be as easy to find for

other types of commercial properties. The individuals and organizations providing such financing and their legal counsel are sophisticated and experienced and often make value-added contributions in terms of due diligence efforts that complement the essential contribution of the funds made available from such sources.

Although a detailed discussion of such financing is beyond the scope of this presentation, significant amounts of equity financing have been raised in recent years through the syndication of low-income housing tax credits made available with respect to certain low-income multi-family projects.

B. Terms of Debt Financing

1. Term of Loan

A developer will want to confirm that debt financing can be obtained for a period of time which will allow the project in question to be developed, completed and leased to a level of occupancy which will support the refinancing or, if applicable, sale of the project. Construction financing typically available today for significant multi-family projects will involve an initial term of 36-48 months with 1-3 one-year extensions available dependent on the absence of defaults, the satisfaction of debt service coverage ratios, loan to value percentages or other financial conditions and the payment of extension fees of typically .20-.25 of one percent of the outstanding loan balance.

2. Cost of Debt Financing

Because of the recent history of low interest rates for new multi-family projects, debt financing for such projects may now be obtained at a cost that is much lower than has traditionally been the case. That situation is true not only with respect to conventionally-financed projects but also with respect to properties such as multi-family projects for low to moderate-income residents or senior citizens which are financed in part with the proceeds of tax-exempt bond financing. The tax-exempt feature of the interest payments on the bonds permits them to be issued at rates that are sufficiently below those prevailing for conventional debt financing to offset the customarily higher costs and regulatory requirements of obtaining tax-exempt financing. Similar savings are available with respect to projects built in tax-increment financing districts of various types.

Many projects are now financed at interest rates based on an agreed differential above the London Interbank Offered Rate, or LIBOR. Some question of the viability of that practice was raised by the disclosures in 2013 of manipulations of the procedures for setting LIBOR, but that news has seemingly been absorbed by the financial markets without lasting harm. From a borrower's perspective, it is relevant to inquire as to whether the lender is actually investing in LIBOR contracts for the specified interest periods or simply basing the interest rate on the loan on the LIBOR index for the corresponding period of time. The loan documents will usually provide that the borrower is liable for any damages caused by the borrower's prepayment of the loan, with such damages consisting of the breakage costs of early payment of an actual LIBOR contract. If there is no actual LIBOR contract, though, and the lender is simply indexing the interest rate on the loan to LIBOR, an argument can be made that there will be no damage created by early payment and the borrower should not be liable for some sort of artificial damages. This argument does not appear to be widely successful.

Loan documents often provide for the applicable interest rate to be "grossed-up" to reflect any regulatory reserve requirements which are applicable to the lender. The economic theory seems sound; since the reserve requirement reduces the amount of money the lender can lend, the lender needs to charge a higher rate on the reduced amount it can lend in order to earn the desired return on the combined amount of the loan and the associated reserve amount. The problem from the borrower's perspective is that reserve requirements vary among lenders, depending upon the regulators' assessment of the degree of risk associated with the lenders' loan portfolios. A well-capitalized borrower might argue that it should not be charged a premium caused by a lender's high-risk reserve requirement. The answer would seem to be making this type of reserve-adjusted calculation of interest based on the lowest risk reserve percentage imposed by the relevant regulator without regard to the risk reserve percentage imposed on the particular lender in question. Again, the borrower's position may not often prevail.

3. Guaranties Required for Debt Financing

Every developer has to face the reality that guaranties of the debt financing will be required by the lender either from the developer’s individual principals or well-capitalized entities within the developer's organization or both. During the development and construction period, these guaranties typically consist of payment guaranties of the entire indebtedness and completion guaranties regarding the construction of the project.

One aspect of completion guaranties that deserves attention is the need to address the effect of the insolvency or closure of the lender that results in the termination of the developer's access to the loan funds on which the developer was relying when the completion guaranty was provided. No developer ever contemplated that the developer itself might have to provide the funds necessary to complete the project pursuant to the completion guaranty. The completion guarantor will want its completion obligation to be

contingent on the continued funding of advances under the loan to pay the costs of construction even if the borrower is in default, as long as the guarantor is not in default. The guarantor will also want the lender to agree that, if the lender elects to have another person complete the project, the guarantor will be liable only for the amount by which the reasonable and necessary costs of construction of the project by the replacement contractor in accordance with the original approved plans and specifications exceeds the amount budgeted for such construction under the loan.

Another troublesome aspect of completion guaranties that needs to be addressed concerns the effect of a foreclosure (or deed in lieu thereof) on the guarantor's obligations. As already noted, a developer has never anticipated having to provide the funds necessary to complete the project (except to the extent that the expected debt and equity funds had been exhausted). A developer has even less of an understanding that it might not only have to provide the money necessary to complete the project but also might have to do so for the benefit of a purchaser at a foreclosure sale (or by deed in lieu of foreclosure) on land in which the developer no longer owns an interest.

When a project is completed and then achieves certain agreed revenue hurdles, the lender may be willing to release or reduce the level of repayment guaranty exposure of the developer except for specified non-recourse carve-out liabilities related primarily to wrongful acts by the developer. One aspect of non-recourse carve-out liabilities that the developer's counsel will want to analyze carefully is the extent to which the occurrence of a carve-out event will give rise to liability only for damages caused by the event or cause the guarantor to be liable for the entire debt. A guarantor will, of course, want most, if not all, of the relevant events to result in liability only for specific damages. A guarantor will want the events that result in full liability to be limited to events that are within the control of the developer, such as voluntary bankruptcy or a sale of the project without the lender's consent. A guarantor will usually be amenable to being liable if the guarantor's affiliate makes a transfer of its interest in the borrower without the lender's consent but will resist being liable if the investor transfers its interest in the borrower without the lender's consent.

An issue that is sometimes overlooked involves the relationship between the carve-out events that are listed in the guaranty agreement and the special purpose entity covenants that are set forth in another document such as the loan agreement. The special purpose entity covenants often include maintaining adequate capitalization within the borrower and not allowing the borrower to become insolvent. If those events are not excluded from the SPE covenants that constitute exceptions to the non-recourse nature of the guaranty, then the guarantor will be subject to full recourse liability in exactly the circumstances under which the guarantor thought the negotiated non-recourse nature of the transaction would provide protection.

Sometimes, lenders will offer to assuage the developer's concern with an SPE covenant requiring the maintenance of adequate capitalization by agreeing that the covenant will not be construed to require the principals of the borrower to make any additional capital contributions to the borrower. This is a potential trap for the guarantor, because the guarantor's primary liability for the loan would be triggered by the breach of the capital maintenance covenant notwithstanding the provision absolving the borrower's principals from having to make any additional contributions.

In recent transactions, the SPE covenants have included provisions that prohibit the borrower from accumulating unpaid trade payables of more than a specified percentage, such as 2%, of the loan amount or letting those liabilities remain unpaid for more than a specified period of time, such as 60 days. In an insolvency situation, such a covenant could come back to haunt a guarantor whose guaranty does not exclude such SPE covenant from the events that will trigger the guarantor's liability. Another aspect of this particular SPE covenant may be the need to be sure that the specified percentage limitation is applied with respect to the entire loan amount, funded and unfunded, to avoid tripping on the covenant during the early portion of the loan term when little or no funds may have been advanced on the loan.

Where an investor has the ability to remove a guarantor or its affiliate as the general partner or managing member of the borrowing entity, the guarantor will want to consider negotiating several issues with the lender. First, as a qualification to the traditional guaranty language saying that the guarantor is not released by amendments of the loan documents, the guarantor will want to include language stating that the guarantor is not bound by changes in the loan documents executed by an unaffiliated successor general partner or managing member that increase the loan amount or interest rate or would otherwise increase the liability of the guarantor. The guarantor will also want the lender to agree to provide separate notices and opportunities to cure default if the borrower's general partner or managing member is at any time not an affiliate of the guarantor. The guarantor will also want to consider requesting to be relieved of non-recourse carve-out liabilities that are caused by a successor general partner or managing member after the guarantor's affiliate has been removed from management control. This issue will be particularly important in connection with actions that give rise to a full springing guaranty on the part of the guarantor such as the filing of bankruptcy or the

encumbrance or transfer of the project without the lender's consent.

4. Required Debt to Equity Ratio

For a number of years, construction financing was provided on the strength of a so-called take-out commitment from a permanent lender to refinance or purchase the construction loan when the construction of the project was completed. In that arrangement, it was not uncommon for developers to be able to finance a project with little or no front-end cash equity.

Take-out commitments became virtually impossible to obtain after the real estate collapse of the late 1980's and it became necessary to finance projects by other means. Typically, those means involve a front-end cash equity commitment in the range of 25-35% of the total development cost for the project that is required to be expended for approved project costs before any of the proceeds of the construction loan can be drawn for the project.

Compliance with the debt to equity ratio is also established by appraisals at the outset of the transaction and periodically during the term of the construction loan. Developers will usually try to resist being required to provide appraisals during the course of constructing a project and will request that appraisals be required only when the loan is made initially and when renewals of the loan are being exercised or negotiated.

5. Transferability Issues

One of the investor's main concern with the construction loan documents will typically relate to the extent to which the investor can transfer its interest in the borrowing entity (or in the single-purpose entity through which the investor owns its interest in the venture) without the lender's consent. The investor will also have a corollary concern with respect to the extent to which the investor can exercise its rights under the venture agreement to remove the developer as the venture manager without the lender's consent. Typically, a lender will be willing to allow the investor to take such actions as long as the developer and its guarantor remain in control or the investor provides an acceptable replacement developer and guarantor.

It is important to the developer to pursue an agreement with the investor that the developer cannot be removed as the venture manager or forced to sell its interest in the venture until the developer and the guarantor have been released from liability for the construction loan and other venture obligations. In some situations, the developer and guarantor may agree to accept an indemnification against such liabilities from a credit-worthy investor or affiliate.

C. Terms of Equity Financing

1. General Considerations

Assuming that the due diligence aspects of the project itself are favorable, the developer still has to demonstrate that the funds necessary to develop and construct the proposed project can be obtained on an economic basis which produces sufficient profit to the developer to justify the risk entailed in the project. It is assumed for this purpose that construction financing is available for the project if the equity financing can be obtained on a basis which is acceptable to the developer and the construction lender. This section of the presentation deals with the terms under which the developer and the equity investor may agree that such equity investment will be made available.

2. Initial Equity Contributions

A typical development transaction today involves third-party, first-lien mortgage financing equal to 65-75% of the total projected cost for development, construction and lease-up. The remaining 25-35% of the financing comes from one or more other sources, including (i) cash equity contributions, (ii) property contributions, (iii) deferral of payment of development fees that otherwise would be included as a legitimate soft cost, payable during construction, and (iv) third-party "soft-debt" participating or mezzanine loans.

Soft-debt participating mezzanine loans commonly are non-recourse and are secured by the ownership interests in the entity that owns the project. They are almost never secured by subordinate liens on the primary real estate because the construction lender does not want any other secured creditors participating in a bankruptcy proceeding involving the project entity or attempting to stay a foreclosure proceeding initiated by the construction lender.

The construction lender usually will require that the equity or soft-debt financing be funded on a "front-end" basis, at the beginning of the project, before any substantial construction loan funds are advanced. Occasionally, a construction lender will be sufficiently comfortable with a particular investor and/or developer that it will permit the equity or soft-debt financing to be funded either as the last dollars invested or to repay a portion of the construction loan on a "back-end" basis when the project has been completed, but such situations are rare.

A developer also may have a bias in favor of obtaining equity or soft-debt financing as early as possible, because the front-end investment minimizes the developer's concern that a failure by the investor to fund a back-end investment will expose the developer to increased likelihood of having to perform on its guaranty of the construction loan. The developer may also believe that the front-end investment will give the investor a greater incentive to make additional mandatory or optional contributions required to fund

future cash needs of the project. The fact that the debt leverage on the project is relatively low will also give some comfort to the developer that its guaranty of the construction loan may not be called upon.

A developer may not make a front-end equity capital contribution to the project, although such contributions may sometimes be required either in the form of cash, deferred developer fees or deferred reimbursement of some pre-development costs. In recent years, a co-investment obligation on the part of the developer has been more common, but such contributions typically represent a significantly smaller percentage of the required front-end equity than the developer’s residual percentage of back-end distributions.

Sometimes, a developer and investor may reach a tentative agreement initially on the terms of their transaction before the costs of the project have been finally determined. In situations such as this, the developer may want the investor to have a binding obligation to proceed with the transaction if the final budget is not more than a specified percentage above the preliminary budget approved by the parties.

3. Obligations for Cost Overruns

The developer will usually agree to be responsible for guaranteeing the so-called "hard costs" of constructing a new project or acquiring and rehabilitating an existing project. Such an obligation is considered to be part of the package of services for which the developer will ultimately receive its fees and promoted interest and is usually not binding until the project has been substantially bid-out. A project's "hard costs" are the material and labor costs expended for the physical construction or acquisition and renovation of a property, including construction supervision and general conditions and the general contractor's fee, and will typically be subject to an agreed contingency amount as a first source of funds to defray cost overruns in individual line item cost categories after savings in other line item cost categories have been exhausted. In some situations, the developer will be able to negotiate a right to recoup any "hard cost" overrun contributions out of net proceeds of sale or refinancing before residual profits are distributed, but more commonly such contributions are non-reimbursable and represent part of the developer's cost of participating in the transaction. Development transactions of the nature being considered here typically involve a guaranteed maximum price contract rather than a fixed-fee or cost plus contract. Sometimes, cost savings on a GMAX contract are retained 100% by the owning entity and, in other instances, the developer is entitled to receive an agreed percentage of any cost savings as an incentive to achieve cost savings to the extent compatible with construction of the project in accordance with the approved plans and specifications. In some cases, a developer will be able to negotiate a construction agreement under which post-completion warranty costs are funded out of any cost savings before they are required to be funded by the developer’s affiliated construction contractor. Developers will sometimes be able to negotiate provisions under which the venture partners will jointly contribute in accordance with their original capital percentages the funds necessary to pay the costs of unforeseeable hard costs overruns caused by unanticipated environmental or physical conditions or changes in governmental requirements, as well as cost increases attributable to enhancements in the scope of a project or upgrades in project amenities. The construction contract for the transaction will need to provide for the guaranteed maximum price of the project to be increased automatically to include any such unforeseeable hard costs overruns or scope change costs.

On the other hand, the parties to an equity transaction will often agree to be jointly responsible for bearing overruns in the so-called "soft costs" of developing and/or rehabilitating and stabilizing a project in accordance with their respective residual profits percentages. A project's "soft costs" include all other categories of costs required to develop, complete and stabilize a project, such as architectural, engineering, legal and other professional fees, permitting fees and other entitlement costs, financing fees and interest costs, marketing and lease-up costs and operating expenses incurred during the development and lease-up period. In retail, office or industrial projects, soft-costs can also include leasing commissions and leasehold improvement costs. These soft costs are subject to variances for events such as changes in regulatory policies, fluctuations in interest rates and delays in implementing the lease-up of a project over which the developer cannot exert much, if any, control. Accordingly, the parties will often agree to shoulder a proportionate mandatory contribution obligation for cost overruns in these categories. Contributions for such soft-cost overruns will usually be characterized as being reimbursable out of future distributions of net cash flow or net proceeds of sale or refinancing as described below. Sometimes, however, the parties agree that such proportionate contributions will be recouped, if at all, simply from the residual distributions of profits.

Recently, the distinction between "hard costs" and "soft costs" has been blurred, with some "soft costs" such as interest, taxes, marketing and lease-up and initial operating income and losses being treated as non-guaranteed items and the remaining "soft costs" being treated as guaranteed. In these instances, the developer is responsible for defraying any overruns in "guaranteed soft costs" but is allowed to use savings in those line items to offset overruns in "hard costs." If

the parties reach an agreement to this effect, it is important for the construction contract to be written in a way that automatically increases the guaranteed maximum price of the constructing the project by an amount equal to the lesser of actual hard costs overruns or guaranteed soft costs savings

In most situations, the developer and investor involved in an equity transaction will agree that contributions required to defray overruns in "non-guaranteed soft costs" and operating deficits which are incurred after the construction or renovation of the project is completed and lease-up has been accomplished will be funded by the parties in accordance with their ultimate residual ownership percentages in the partnership or in accordance with ownership percentages between their original capital percentages and their ultimate residual percentages. The obligation to make such additional contributions is often characterized as being a non-recourse liability, however, which is enforceable only by means of a dilution or loss of the defaulting partner's interest in the partnership. Dilution provisions are often difficult to negotiate because of (i) uncertainty as to the projected equity value of the project to be used as the denominator of the dilution formula and (ii) differences of opinion as to the weight to be given defaulted contributions by the developer and the investor in comparison with each other, in light of the fact that the investor's original contributions are usually in the form of cash and the developer's original contributions are usually in the form of so-called "sweat equity" and/or a disproportionately small amount of cash. This difficulty is often resolved by using a "default loan" procedure under which a defaulting partner's share of an additional capital contribution is provided by other partners by means of a deemed loan to the defaulting partner that is paid (with bonus interest) from amounts that would have otherwise been distributed to the defaulting partner in the future.

In a soft-debt participating or mezzanine loan transaction, the absence of a partnership structure requires that special attention be paid to the issue of whether and how the participating lender should make contributions to defray soft cost overruns and operating deficits. This issue is compounded by the fact that the interest on the participating debt financing will ordinarily be payable at stated rates and intervals, as opposed to the distribution of a preferred return as and when available as would be the case in a true equity transaction. Sometimes, this funding question is addressed by making additional loan proceeds available, while other lenders prefer to provide for an interest accrual feature under which interest that would otherwise be payable on the loan can be accrued to the extent it exceeds operating cash flow, ordinarily subject to some maximum amount of such accrual. The soft-debt investor will often also allow the developer to obtain reimbursement from future sale or refinancing proceeds, prior to the distribution of residual proceeds from such transaction, with respect to some or all of the contributions which the developer may make to defray soft cost overruns and operating deficits.

4. Preferred Return on Equity Contributions.

The preferred return which the investor will receive on its equity capital contributions is a negotiated amount that is greatly influenced by the market rate for similar investment funds. The investor's expectations must be reasonable in that context, of course, or the developer will either find an alternative source of capital or will ultimately deem the project to be unprofitable and walk-away at the earliest opportunity. The expectations of the investor will also be affected by the reputation, experience and financial condition of the developer, while the developer's expectations will be affected by the degree of difficulty that might be encountered in trying to locate another source of equity capital. Recent transactions in which the author has participated have provided for the investor to receive an internal rate of return on its contributions of as much as 15% before the developer would be entitled to any residual profit sharing distributions which are not attributable to the developer's own capital contributions.

5. Residual Distributions.

The ultimate goal of the typical developer is achieving a residual interest in the profits realized on the project upon ultimate sale which is as large as possible. The developer's share of the residual profits, or the "promote," is the pot at the end of the rainbow for most developers. That is the feature of the project which confirms how well the developer has performed in developing, constructing and operating the project and the element of the transaction which produces the ultimate pay-day when the project is sold or refinanced. The determination of that feature of a transaction is highly negotiable and can be affected by numerous factors. It would be unusual, however, to see a developer's residual profit-sharing percentage below 20% or above 50%. One aspect of the negotiation is the extent, if any, that the developer's own capital percentage will be promoted by the developer's residual percentage. A developer's usual objective is achieving an arrangement under which all of the developer's promoted interest is taken from the investor's capital percentage. For an excellent discussion of the complex analytical factors involved this issue see Carey, Real Estate JV Promote Calculations: Basic Concepts and Issues (Updated 2013), *The Real Estate Finance Journal*, Thomson Reuters (2013).

6. Allocations of Profits and Losses

Although partners have a great deal of flexibility in allocating profits, losses and other tax attributes among themselves in a partnership agreement, there are several limitations on that flexibility. First, such allocations must have the minimum substantial economic effect which is required by Section 704 of the Internal Revenue Code of 1986, as amended (the "Code"). Second, such allocations must operate in a manner which supports the economic agreements of the parties with respect to the procedures for making distributions by the partnership. Third, such allocations must operate in a manner which does not produce unintended or disproportionate tax consequences for the partners. These limitations are discussed in further detail below.

Although it is not the intent of this presentation to deal with the issue of substantial economic effect in detail, it has been the author's experience that the provisions inserted in partnership agreements to address this issue sometimes do not deal adequately with the economic objectives which are of paramount importance to the principals to the transaction. It has become fairly common practice to include in a partnership agreement catch-all liquidation provisions which provide for liquidating distributions to be made in accordance with final capital accounts as a safeguard against the disallowance of special allocations (even where no special allocations of losses were made in the first place). The author certainly has no quarrel with the inclusion of such provisions, but they are often used without sufficient attention being paid to the need to include allocation provisions which will produce the desired positive capital accounts with reference to which such liquidating distributions are supposed to be made.

For example, it is common to see partnership agreements where the investor is supposed to receive a return of its unrecovered capital contributions plus a preferred return on those contributions before the developer receives any distributions. In the provisions dealing with the distribution of the proceeds of sale or refinancing, that priority will be made clear. The provisions dealing with liquidating distributions, however, are often not supplemented by provisions which make special allocations of profits to the investor equal to the amount by which the investor's positive capital account immediately prior to such allocation is less than the sum of the investor's unrecovered capital contributions and cumulative preferred return. If that special allocation of profits is not made, then the investor may receive a smaller share of the total liquidating distributions than the parties intended, and the developer may receive a larger share of those distributions than it should. This result occurs because the final pro rata allocation of profits would augment the developer's positive capital account by a greater amount than intended, and the subsequent liquidating distributions in accordance with positive capital accounts would automatically produce such disproportionate distribution to the developer.

The opposite result can occur with respect to the parties if the partnership agreement does not make a special allocation of profits to the developer equal to any secondary priority which the developer is supposed to receive. For example, the developer may be entitled to a secondary priority in recognition of the fact that the developer waived or reduced its customary developer's fee during the construction of the project. If a special allocation of profits in that amount is not made before the final pro rata allocation of profits is made at the time the partnership is liquidated, and liquidating distributions are made in accordance with final positive capital accounts, the liquidating distributions received by the developer will not reflect that secondary priority amount.

Another area where the author has often encountered unintended consequences of this nature involves the relationship between provisions regarding net cash flow distributions and provisions pertaining to the allocation of taxable income from operations. Very often, net cash flow distributions are supposed to be made to the investor until the investor has received an amount equal to the current and accumulated preferred return on the investor’s unrecovered capital contributions. Taxable income from operations, on the other hand, is often supposed to be allocated first to offset taxable losses previously allocated among the partners and then pro rata among the partners in accordance with their respective residual ownership percentages. The interaction between these distribution and allocation provisions can seemingly result in a situation where the investor receives all of the net cash flow from operations, but the developer may have to recognize some of the taxable income attributable to such net cash flow. A better approach, it is believed, is one where taxable income is first allocated in accordance with cash flow distributions before it is allocated to offset prior loss allocations and then in accordance with residual ownership percentages.

Because of the investor's customary insistence on receiving a return of the investor's capital contributions (with or without any agreed preferred return) before the developer receives any distributions of the proceeds of sale or refinancing, there is usually not a front-end shift of capital which would give rise to "phantom" taxable income to the developer at the inception of the partnership. A corollary of this issue may arise, however, if the developer receives some sort of credit for development fees accrued during the course of construction. It seems that such credit should not give rise to taxable income by itself, as it represents nothing more than a claim on future profits from sale or

refinancing. If such credit is granted a priority over the investor's unrecovered capital contributions at the time the credit accrues, though, then a shift of capital may have occurred which is required to be recognized as income by the developer at that time. It is less clear what the result should be where the development fee credit begins to accrue a preferred return from the time the credit is earned, but the credit and the preferred return continue to be subordinate to the investor's unreturned capital contributions. It seems that no taxable event will have occurred in such a situation until the credit and return actually result in a distribution to the developer of future proceeds of sale or refinancing, but that conclusion is not free from doubt.

7. Distributions

Generally, net cash flow available for distribution will be distributed first to the partners that are entitled to receive a preferred return until the full amount of that preferred return for the current year and prior years has been received. Usually, net cash flow will thereafter be distributed to the partners in accordance with their residual profits percentages, although some investors require that some or all of such excess net cash flow be applied as a repayment of the investors' original capital contributions. Unless there is a special arrangement of that sort, excess net cash flow received by an investor above its preferred return for a particular year will usually not be applied to reduce the investor's unrecovered capital contributions, although that kind of an arrangement is not totally unprecedented.

The negotiations between the parties will usually include the questions of whether the preferred return to be received by the investor is cumulative and whether it is to be computed on a simple or compounded basis and, if compounded, with what frequency. An arrangement for the preferred return to be cumulative and compounded monthly or annually seems to be customary in many situations. Some partnership agreements provide for the preferred return or interest rate computations to be made in accordance with internal rate of return calculations at the negotiated rates. It should be noted, also, that some institutional investors require that the preferred return or interest payments on their equity or soft-debt contributions be paid at stated intervals as an operating cost of the partnership regardless of whether funds are otherwise available to pay those amounts. Commonly, the obligation to fund deficits resulting from these distribution requirements is shared proportionately by the parties in accordance with their ultimate residual sharing percentages on a non-recourse basis.

A developer will sometimes seek a special provision that causes preferred return which accrues during the construction period to be payable only out of future proceeds of sale or refinancing. This avoids building-up such a substantial amount of accrued preferred return during the development period (when there is no chance of realizing cash flow to pay it) that it becomes highly unlikely that the developer will receive any residual net cash flow distributions during the early years of operation of the project. Some investors are willing to agree to such a provision because they want the developer to have an immediate financial incentive to produce significant net cash flow distributions from the operations of the project as quickly as possible. In other cases, however, the investor may want to receive distributions of preferred return on a current basis throughout the development and construction period, in which event that cost has to be taken into account as part of the development budget for the project. In a situation of this latter type, the investor's committed capital contribution obligation may be sized to include the estimated funds necessary to fund the payment of a return to the investor during the development and lease-up period.

However the parties may have agreed to allocate the obligations to make additional capital contributions for soft-cost overruns and operating deficits, some understanding must be reached regarding the manner in which those contributions will be recovered out of future distributions. If the additional contributions are made by the partners in accordance with their residual ownership percentages, then the parties often will agree that the additional contributions should not bear any interest or preferred return. If the additional contributions are made disproportionately to the residual ownership percentages, however, then an interest factor or preferred return usually is demanded, and such compensation may be greater than the preferred return on the initial capital contributions. The priorities for recovering such additional contributions are negotiable — the parties will need to decide whether the contributions will be recouped before or after the investor's front-end equity contribution (and any preferred return thereon) has been distributed, or before or after any contributions by the developer or deferred portion of the developer's development fee (and any preferred return thereon) has been paid. It is often important to the success of the transaction to give priority to the distribution of additional contributions and the higher preferred return thereon in order to provide additional incentive for the parties to make such contributions when the project may not be performing as well as they had originally contemplated.

The parties providing equity or soft-debt financing typically will be entitled to receive essentially all proceeds of sale or refinancing from the transaction (subject to the method used to recoup additional contributions, as discussed in the preceding paragraph) until they receive an amount equal to their original contributions plus the unpaid amount of the preferred

return or interest on those contributions. To the extent that the developer contributes actual cash amounts as part of the initial capital contributions, it will often participate in the distributions attributable to those capital contributions and preferred return on a pro rata basis with the investors. If the developer makes its initial contribution in the form of deferred fees, then it typically will receive a distribution equal to the deferred fees from the proceeds of sale or refinancing of the project after the investors have received their original capital and the preferred return on that capital. Often, the developer will ask that the deferred fees bear a preferred return calculated on the same basis as the preferred return received by the investors, but the calculation period may not begin until the construction of the project has been completed (or pro rata as the development fees are earned). Because the developer will not actually receive the economic benefit of these deferred fees until residual profits realized on the sale or refinancing of the project are distributed, the developer often will want to characterize this distribution as a secondary capital transaction preference from the proceeds, rather than as deferred fees, hoping that such characterization of the nature of the distribution may support a more favorable characterization of the distribution for income tax purposes.

One typical economic distinction between a true equity situation and a soft-debt transaction is that there will usually be no time agreed upon by which the equity is required to be returned, while the debt will have a maturity date. If the project has not been sold prior to the maturity date of the debt, the project entity will be obligated to retire the debt and pay the participating lender an agreed percentage of the amount by which the appraised value of the project at that time exceeds the sum of the principal and accrued interest on the mortgage debt against the project and the participating debt which is secured by the interests in the ownership entity. If the mortgage debt on the project is refinanced prior to the maturity date of the participating debt financing, the mezzanine lender may have an option either to obtain the full amount of its participating interest at that time based on the appraised value of the project or to receive the net refinancing proceeds for application toward the participating interest at that time and retain the right to receive the balance of the participating interest in connection with a future sale or refinancing or at the maturity of the participating loan.

It should be noted that the developer usually does not guarantee the return of either the principal or preferred return of equity capital contributions or the principal or interest of mezzanine loans. The developer and its principals customarily do provide guaranties of project completion, environmental liabilities and "carve-out" obligations for the benefit of both equity investors and mezzanine lenders.

Because of potential usury concerns with the characterization of participating interests in profits in connection with mezzanine loans, such transactions have usually been characterized as being governed by the laws of states other than Texas which do not have usury limitations. These concerns may have been ameliorated to some extent by the amendments of the statutory provisions regarding the calculation of interest which were enacted by the 1997 session of the Texas Legislature and are now embodied in Chapter 306 of the Texas Finance Code. See, Acts 1997, 75th Leg., ch. 1396, section 1 et seq., effective September 1, 1997.

Under the provisions of Chapter 306 of the Finance Code, the concept of a "qualified commercial loan" is created, which is a commercial loan of either $3.0 million or more that is secured by real estate or $250,000 or more that is not secured by real estate or a renewal of either type of loan regardless of the amount of the loan at the time of renewal. Of particular importance here is the fact that the provisions of Chapter 306 expressly authorize and exclude from the definition of "interest" various forms of profit participation, equity participation and similar features.

In some cases, investors may insist on using some sort of preferred equity distribution arrangement to reflect enhanced risk factors or negotiating leverage. In such situations, the investor will receive distributions equivalent to its additional capital contributions and the preferred return thereon before the developer receives similar distributions. Likewise, the investor will receive distributions equivalent to its initial capital contributions and the preferred return thereon before the developer receives similar distributions. The investor may then insist on receiving distributions at a lower percentage until the investor receives a higher catch-up internal rate of return, with a final tranche of residual distribution percentages that are lower for the investor and higher for the developer after that catch-up internal rate of return has been achieved.

8. Development Fee

A developer will ordinarily expect to be paid a development fee equal to an agreed percentage of the total development budget for the project. That percentage is negotiable but often equals 2-3% of the total development budget (with or without land). In some instances, the development fee is payable in approximately equal installments over the contemplated period for development and construction or in monthly installments that are pro rata with the monthly advances of construction costs. In other cases, part of the development fee is paid in that manner and part is paid upon completion and/or sale or refinancing of the project. Sometimes, a developer can negotiate a

front-end payment of part of the development fee at closing in consideration of the extensive pre-development work the developer will have performed at that time. These funds are intended largely to reimburse the developer's cost of doing business and provide some modest level of profit to the developer.

9. General Contractor's Fee

A developer of the type of project being considered here will also typically serve as the general contractor for the project. In that capacity, the developer will receive a general contractor's fee equal to an agreed percentage of the construction budget, which is customarily paid pro rata as construction costs are expended for the project. A typical construction contract will provide for a 5-6% contractor's fee and a contingency of 2-4% of the construction budget. As noted earlier, the developer may also participate in construction savings under a construction contract.

10. Property Management Fees and Leasing Commissions

Most developers will have property management and leasing operations which they will want to employ in providing those services to the contemplated project. The developer's objective will be not only to generate fees in usual and customary amounts as compensation for those services but also to enhance the value of the property for purposes of increasing profits on sale and reducing exposure for loan defaults and calls on loan guaranties. Property management fees are very competitive and have declined considerably in recent years. A fee of 2-3% of gross receipts is often seen. Residential projects do not typically incur leasing commissions (as opposed to apartment locator fees) but those commissions have to be carefully negotiated between the developer and the investor in connection with other types of development projects.

11. Condominium Conversion Restriction.

The general contractor for many apartment complexes is affiliated with the developer. In this situation, the question arises as to the extent, if any, which implied warranties concerning the quality of the contractor's work can be effectively disclaimed in a sale contract and disclaimer provisions in the deed conveying the property to the initial buyer from the entity that owned the property during the construction period. The problem of implied warranties of construction becomes particularly acute if the property is subsequently converted to a condominium regime and the resulting condominium units are sold to individual buyers. There have been many construction defect lawsuits against developers by condominium owners associations and/or their members that might have been avoided if the properties had not been converted to condominium regimes.

This problem has given rise to the technique of imposing restrictions on condominium conversions in the deeds conveying multi-family properties to the first buyer from the entity that owned the property during construction. Such restrictions typically extend for the duration of the statute of repose in the relevant jurisdiction and prohibit condominium conversion during the restricted period unless the converter provides insurance acceptable to the original owner protecting the original owner and the developer and their respective affiliates against claims for construction defect liabilities initiated after the conversion.

In order to avoid an argument over the issue with an investor at the time a sale is being negotiated, a developer might want to consider including in the document creating the project entity a provision requiring such a condominium conversion restriction to be included in any sale contract unless the developer waives that requirement.

12. Exit Strategies

Two types of exit strategies will be highlighted here; exiting the construction loan and exiting the venture.

A developer will want to have a strategy from the outset for refinancing the construction loan and getting released from the guaranty of that loan without the necessity of obtaining the approval of the equity partner. Otherwise, the developer may get trapped on the loan and required to continue funding deficits because the investor will not approve any replacement financing. In order to avoid this problem, the developer will want the venture documents to contain a provision authorizing the developer to obtain replacement financing without the investor's consent. Section 4.05 of Appendix A sets forth a sample provision dealing with this issue.

A developer that is a merchant-builder as opposed to an investment-builder will also want to have a strategy for initiating a sale of the property to the investor or a third party. Article XIII of Appendix A sets forth sample provisions dealing with this issue.

13. Recent Case on Fiduciary Duty

A New York state trial court issued an opinion under Delaware law two years ago that poses significant concerns for commercial real estate developers. *See, Lichtenstein, et al. v. Wilkie Farr & Gallagher, LLP, et al.*, Supreme Court of New York, County of New York, Index No. 652092/12 (April 22, 2013). In that case, a developer had signed a $100 million springing guaranty that was triggered by the bankruptcy filing of the borrowing entity affiliated with the developer. The guaranty was issued in connection with acquisition loans totaling $7.4 billion. The developer claimed that the defendant law firm had

committed malpractice by advising him that he would be subject to unlimited personal liability to the creditors for allowing the waste of the borrower's assets if he refused to cause the borrower to file the bankruptcy proceedings that would trigger his springing guaranty. Based on that advice, the developer caused the borrower to file bankruptcy. The creditors then obtained judgments against the developer for $100 million on the springing guaranty. *See, Bank of America NA v. Lightstone Holdings LLC,* 32 Misc.3d 1244(A), 938 N.Y.S.2d 225 (Table), 2011 WL 4357491 (Sup. Ct. N.Y Cty., July 14, 2011. In the 2013 case, the developer had filed suit against the law firm for $100 million in damages on the grounds that the law firm had committed malpractice in advising the developer that he had a fiduciary duty to cause the borrower to file bankruptcy and that he should take that course of action in order to avoid the unlimited damages that might be incurred if he did not do so. In the cited opinion, the court dismissed the developer's complaint against the law firm.

A springing guaranty triggered by bankruptcy is a nearly universal feature of modern commercial real estate financing transactions. It is a result of a decades-long tug of war between lenders and developers over the proper balance between recourse and non-recourse liabilities for commercial loans. Full non-recourse financing became widespread in the 1970's because of the favorable income tax effect of such financing. Over the ensuing years, the concept of non-recourse carve-out liabilities began to emerge. When real estate development eventually resumed in the early 1990's after the real estate debacle triggered by the Tax Reform Act of 1986, lenders took the position that developers could continue to have some limited form of non-recourse financing, but that position was conditioned on the developers not putting the borrowers into bankruptcy. So, the concept of a springing guaranty triggered by bankruptcy became a standard commercial financing term.

What the recent *Lichtenstein* opinion highlights is a potentially irreconcilable conflict between the springing guaranty triggered by bankruptcy and the fiduciary duty of the guarantor or its affiliates to the borrower's other owners and/or creditors with respect to the initiation of bankruptcy in order to prevent the waste of the borrower's assets. Consideration is now being given to whether this fiduciary duty may be waived. See, e.g., Lefkort, *An Ounce of Fund Document Protection is Worth a Pound of Litigation Cure Later: Waivers of Fiduciary Duties in Fund Documents*, The Investment Lawyer, Vol. 20, No. 3 (March 2013). Efforts to insert such waivers into the organizational documents for project entities would certainly seem to be justified. Moreover, as counter-intuitive as it may seem, consideration might also be given to negotiating such waivers in loan documents, so as to forestall an argument by a lender that a guarantor has a fiduciary duty to the lender to file the very bankruptcy proceeding that is going to trigger the guarantor's springing guaranty.

14. Sample Joint Venture Agreement – Appendix A

Attached as Appendix A is a blank form of an Amended and Restated Company Agreement that is based on similar agreements that the author has previously negotiated on behalf of developers for transactions with private cash equity investors and private landowners who contributed land to the venture for the project.

III. CONCLUSION

The issues discussed above arise at the intersection of the legal and business aspects of real estate development transactions. Consequently, the efforts of both clients and their legal counsel are required to assure that the issues have been identified and resolved in a manner that is consistent with the clients' objectives for the transaction involved.