SELECTED DEVELOPMENT ISSUES

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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 fourteen-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. He served 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, which recently named him as one of its five 2016 Outstanding 50 Year Texas Lawyers.

Texas Lawyer chose 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 2003-2015 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 designated as one of San Antonio's Best Attorneys in Scene in SA Monthly in 2004-2015.

He was listed in The Best Lawyers in America (Real Estate) (1987-1988 and 1997-2015) 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).

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 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 is a member of the Founders Council of the Embrey 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 recently served on the Relocation Committees for the San Antonio Children's Museum and Dress for Success – San Antonio.

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SELECTED DEVELOPMENT ISSUES

I. INTRODUCTION

This presentation describes some issues which the author has encountered in representing real estate developers and discusses the manner in which those issues were resolved. It should always be remembered that the relative negotiating leverage of the parties involved in a particular transaction is the most important factor influencing whether such issues can be successfully resolved. Even if that leverage is unfavorable in a given situation, however, legal counsel may want to raise the issues for consideration by their clients in order to assure that professional responsibility has been satisfied.

It should also be kept in mind that the author represents developers primarily, which undoubtedly results in some bias on how these issues are viewed. The contrary positions of the sellers, lenders or investors involved in a particular transaction regarding the manner in which these issues should be resolved will usually have a degree of merit that the developer's counsel will required to overcome in order to be successful.

Finally, although some of these issues may seem elementary, they can quickly become major problems if they are not recognized and addressed. They can also arise in both small and large transactions.

II. SELECTED DEVELOPMENT ISSUES

A. Building Compulsion Provisions

Sellers will sometimes seek to impose building compulsion provisions in contracts to sell land to developers. A recent transaction involving such provisions was the genesis of the author's decision to prepare this presentation.

Historically, building compulsion provisions regarding commencement of construction have been viewed as somewhat of a nuisance but not significantly troublesome. The developer's negotiating objectives were to obtain a long period for commencement, a minimal definition of what constituted commencement, at least some notice and right to cure before the repurchase option could be exercised and as favorable a repurchase price as possible. Since construction had, by definition, not commenced, the potential loss on the transaction consisted principally of pre-development costs that had been funded at the land closing and any "haircut" on the land repurchase price that had been exacted by the seller in the sale contract. The process of commencement of construction did not ordinarily involve undue risk and a failure to satisfy the commencement condition did not usually involve a potentially large economic loss.

On the other hand, building compulsion provisions regarding completion of construction have been viewed much more seriously by developers and their legal counsel. A completion condition involves a much greater risk of non-compliance and non-compliance usually involves a much larger potential financial risk. Those increased risks of a completion compulsion involve a construction lender and equity investor to a much greater extent than they are involved in the risks of a commencement compulsion.

The recent transaction which we are discussing here involved both a commencement compulsion and a completion compulsion. The transaction also involved a developer, a construction lender with which we had not dealt previously and an institutional investor with which we had previously negotiated a couple of transactions. The transaction also involved the sellers of a site for the proposed apartment project that was located within a larger mixed-use development. The land sellers purportedly had encountered a situation in the past with this or another large development where a buyer of a site within a development had failed to complete construction of the contemplated improvements on a site after it was sold. That history was cited as the reason for the commitment the sellers had to the completion compulsion in our transaction.

The building compulsion in the land acquisition contract for this situation consisted of both a commencement compulsion and a completion compulsion. The developer would have a year plus some limited force majeure time to commence construction, with commencement being defined in terms of site grading, which was viewed as being favorable to the developer. If that commencement requirement were not satisfied, then the sellers could repurchase the land for an amount equal to eighty percent (80%) of the purchase price for the land. If the developer did satisfy the commencement condition, then the developer would have three years after commencement of construction plus some limited amount of force majeure time in which to complete construction. If that completion requirement were not satisfied, then the sellers could repurchase the land and improvements for an amount equal to the sum of the fair market value of the improvements and an amount equal to eighty percent (80%) of the purchase price for the land. The land sellers knew that the developer had significant concerns regarding the potentially adverse impact that these contractual provisions might have on the developer's ability to obtain debt and equity financing for the project. The land sellers were not unsympathetic to the developer's concerns and had indicated that they might have some flexibility to make

concessions if necessary to enable the developer to obtain the project financing.

In beginning to prepare for closing and negotiate the project financing, we identified one fairly simple change in the building compulsion provisions that would benefit the developer. A request was made to the land sellers to amend the completion condition so it would require completion within four (4) years after the land purchase plus limited force majeure time rather than three (3) years after commencement of construction plus limited force majeure time. That way, the developer would derive the benefit of commencing construction as soon as possible and have a much longer period of time in which to complete construction. Since the requested change did not result in a change in the overall time in which the developer had to complete the project, the land sellers were expected to agree with the requested change and they subsequently did do so.

The next step in solving the problem was much more significant and not nearly as expected. The construction lender requested that the land sellers subordinate their repurchase rights under the building compulsion provisions to the liens securing the construction loan. And the land sellers agreed to grant that request. In view of the commitment to the building compulsion provisions that the land sellers had expressed consistently throughout the negotiations of the land purchase contract, their acquiescence on this issue was quite a surprise. Nevertheless, the construction lender would now be able to foreclose the liens securing the construction loan and wipe out the rights of the land sellers under the building compulsion provisions if the developer created a default on the construction loan by failing to perform its obligations under the building compulsion provisions. We had not contemplated that the suggested flexibility of the land sellers would be that significant. One can only surmise that the land sellers assumed that a construction lender would not foreclose on an unfinished project and leave it unfinished, which was the land sellers' professed concern all along.

The final piece of the solution to the puzzle came from the investor. Since the investor would be investing more than thirty percent (30%) of the cost of the project before the construction lender would be required to make any disbursements under the construction loan, the investor actually had a much more immediate exposure to the building compulsion provisions than the construction lender did. The investor's solution to that problem was to negotiate an option agreement with the construction lender which allowed the investor to purchase the construction loan. Exercising that option would effectively make the position of the land sellers subordinate to the position of the investor if the building compulsion provisions became a problem.

So, the potential hurdles to financing the project originally presented in this instance by the building compulsion provisions were ultimately resolved by a combination of efforts among the land sellers, the construction lender and the investor and their respective legal counsel, with a quite modest contribution on the part of the developer and its counsel.

B. Due Diligence Issues and Exit Strategy

A prime objective of due diligence efforts on behalf of developers is to resolve issues that arise during the pre-development stage of transactions in a manner that will satisfy not only the lender and investor involved in the initial development of a project but also a future lender or buyer of the project.

A recent example of this objective occurred in connection with a requirement that a developer obtain approval of its plans and specifications for a project from the architectural control committee of a property owners association. The developer's representatives obtained a letter that said unequivocally that the developer's plans and specifications had been approved by the committee. However, the letter did not identify the approved plans and specifications in any manner. The investor's representatives required a replacement approval letter to be obtained that identified the approved plans and specifications in an objective, detailed and specific manner in order to foreclose any questions in the future regarding the efficacy of the committee's approval or exactly what the committee had actually approved.

C. Availability of and Security for Self-Help Remedies

Development transactions frequently involve agreements by land sellers or other third parties to extend utilities to the project site or perform other work necessary for the development of the project. Such agreements must not only describe clearly the work to be performed but also be secured by adequate escrowed funds and permit the developer to exercise self-help remedies to complete the required work if the other party does not perform the work in a timely manner. Such self-help remedies should be accompanied by provisions granting the developer access to any off-site property on which such work must be performed, as well as rights to draw on the escrowed funds to pay the costs of completing the work. Any escrowed funds remaining after the work is completed will ordinarily be disbursed to the land

seller or other third party if they complete the required work. The disbursement of any escrowed funds remaining after the work is completed by the developer is often a matter of negotiation between the parties.

D. Off-Site Infrastructure and Easements

Some of the thorniest problems we have encountered in the past year or so involved off-site access and other easements and off-site improvements such as drainage and detention facilities, many of which involved the kinds of issues described in the preceding section.

Another common problem with off-site easements and other facilities is the existence of liens encumbering the land on which such easements or facilities are located (or are to be located) that would eliminate the rights of the party intended to benefit from such easements or facilities if the liens were foreclosed. Often, the subject project cannot proceed at all unless the holder of such liens is willing to subordinate its liens to the rights of the owner of the subject project. Sometimes, unless the adjacent property is owned by the seller of the subject property, or the same lender holds the liens on both properties, it may be difficult to identify an adequate incentive for the lender holding the liens on the adjacent property to agree to such subordination.

E. Purchase of Property Encumbered by Debt Exceeding Purchase Price

We were involved in a development transaction a few years ago in which the tract of land for the project was encumbered by debt in excess of the purchase price. The debt was secured by several tracts of land in addition to the tract on which our client's project was intended to be built. Shortly before the closing, it was disclosed that the seller was in precarious financial condition and might file bankruptcy before the closing. Moreover, the original lender had failed and the replacement lender brought in by the FDIC was resisting the notion of releasing the subject tract of land in exchange for a partial payment on the debt equal only to the net purchase price for that tract and not the entire amount owed by the seller. By this time, the developer had incurred almost $1.0 million in predevelopment costs that would be lost entirely if the purchase of this tract of land could not be closed. On the other hand, the excess debt was an amount that the developer did not want to add to the already high cost of the land for the project. Fortunately, we were eventually able to negotiate a partial release agreement with the replacement lender and close the purchase of the land without paying the extra debt, thus avoiding the loss of the predevelopment costs. The replacement lender was apparently persuaded that the substantial portion of the debt that would be received if the closing were consummated, justified granting the partial release

This experience was unnerving, to say the least, and we tried to learn something from the episode. We decided that, if a similar situation was encountered in the future, we would attempt to negotiate a provision in the land purchase contract which provided that the feasibility period would not begin until the seller had provided the buyer with an enforceable agreement executed by the lender agreeing to accept the net sale proceeds as consideration for a partial release of the liens encumbering the tract being purchased. [1] This solution was dependent, of course, on our learning about the excess debt prior to the execution of the purchase contract. As a practical matter, we would not ordinarily learn of the excess debt until the title commitment is received, by which time the feasibility period would have almost always already begun. Perhaps a provision to be included in the purchase contract which would suspend the feasibility period for the time necessary to negotiate the partial release agreement with the lender could be negotiated, but we have not negotiated such a provision. We are continuing to explore possible and practical solutions to this problem. Based on our earlier experience, the problem deserves a solution.

III. SELECTED FINANCING ISSUES

A. Completion and Payment Guaranties

Dealing with the construction lender for the first time in the transaction described previously involved a need to negotiate some features of completion and payment guaranties that the author has discussed in other recent presentations and will not belabor here beyond some brief mentions.

The initial drafts of the completion guaranty in this transaction included a provision which said the guarantor would be liable for all remaining costs of constructing the project if the borrower defaulted and the lender decided to finish the construction itself or through another contractor rather than having the guarantor complete the construction. The lender eventually conceded that the proper measure of damages in that situation would be the amount, if any, by which the remaining cost paid by the lender to

[1] The concept of enforceability in the preceding sentence refers to the *D'oench Duhme* common law and statutory requirements which must be satisfied in order for agreements with FDIC insured lenders to be enforced if they are taken over by the FDIC. See, Chris Atkinson, *Defending the Indefensible: Exceptions to D'oench and 12 U.S.C. §1823(E)*, 63 Fordham L. Rev. 1337 (1995).

complete the construction pursuant to the approved plans and specifications exceeded the remaining funds budgeted for such work in the loan after allocation of cost savings and contingency amounts.

We were unable to negotiate a provision under which the guarantor's liability under the completion guaranty would be terminated by a foreclosure of the liens securing the loan, but it was understood that, as a practical matter, the lender's remedy in such situation would be limited to the same proper measure of damages that is described in the preceding paragraph.

We were able to negotiate a provision in the payment guaranty for this transaction which gives the guarantor the right to obtain confirmations from the lender as the various hurdles to reducing the guarantor's liability under the guaranty are satisfied. A guarantor will want to have procedures in place to request such confirmations routinely as they soon as they become available in order that they can be presented as proof should any question about the reductions in liability arise in the future.

We were unsuccessful in negotiating a provision that we ordinarily pursue in connection with payment guaranties that would have shielded the payment guarantor from springing recourse or carve-out liabilities which arise when the managing member or general partner of the borrower is not an affiliate of the guarantor. The investor's recognition of the merits of the guarantor's concerns about such a situation did, however, enable us to negotiate some additional protections from such liabilities in the borrower's joint venture agreement.

B. Assignment of Construction Lender's Rights and Obligations

Construction loan agreements typically contain provisions permitting the lender to assign its rights and obligations with respect to the loan without the consent of the borrower. Such provisions often include language such as "after any such assignment, the rights and obligations of Lender and its assignees shall be as they shall have agreed among themselves." A quick look at that language will alert the reader to the lurking problem. The borrower has just negotiated and closed a loan transaction and paid a significant loan origination fee to a lender which the borrower has selected to finance a more or less substantial real estate project. But now the lender is saying it can assign its obligations to another person without restriction and walk away from the lender's obligations to the borrower with impunity, regardless of the assignee's lack of ability to perform the lender's obligations or the assignee's failure to perform those obligations. That would not be a good result and efforts should be made to avoid that possibility.

C. High Velocity Commercial Real Estate Loans ("HVCRE") [2]

Under recent changes in banking regulations, acquisition, development and construction ("ADC") commercial real estate loans that are classified as High Velocity Commercial Real Estate Loans ("HVCRE") are assigned a 50% higher risk weight than was previously applicable in establishing reserve requirements for regulated lenders. Consequently, lenders have begun imposing the following restrictions on ADC loans in order to assure that they are not classified as HVCRE:

(a) The loan-to-value ratio must be equal to or less than the following percentages: (i) raw land – 65%; (ii) land development – 75%; (iii) construction of commercial, multi-family and other non-residential – 80%; (iv) construction of 1-4 family residential – 85%; and (v) construction of improved property – 85%;

(b) The borrower must contribute capital to the project in the form of cash or unencumbered readily marketable assets (or pay development expenses out-of-pocket) in the aggregate amount of at least 15% of the project's appraised "as completed" value (as opposed to its "as is" value or "as stabilized" value); and

(c) The borrower must contribute the required 15% of capital before the lender advances any proceeds of the construction loan and the capital contributed by the borrower or internally generated by the project must be contractually required to remain in the project for the life of the project; *i.e.*, until the project is sold, the construction loan is replaced with permanent financing or the construction loan is otherwise paid in full.

The regulatory guidance regarding HVCRE makes clear that cash may be used to purchase land which is then contributed to the borrower before any proceeds of the loan are advanced and that such cash will be

[2] The term "regulatory guidance" is used in this discussion to refer to the Frequently Asked Questions on the Regulatory Capital Rule issued by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation dated March 31, 2015.

taken into account in satisfying the 15% minimum contribution requirement. No mention is made of whether the potentially more tax-efficient arrangement of contributing land directly to the borrower will permit the agreed value of the land to be taken into account in satisfying that requirement. The mention of readily marketable assets in the rule would seem to militate against such an interpretation. A similar conclusion would seemingly be applicable with respect to the contribution of a contract to purchase land that has appreciated in value since the purchase contract was negotiated. These concerns may not be relevant, of course, if sufficient cash is being contributed to satisfy the HVCRE 15% minimum equity requirement, and such contributions of land or a contract to purchase land can presumably be taken into account in satisfying the lender's separate (but inclusive) 25-35% minimum front-end equity requirement.

Contrary to some commentary, the regulatory guidance regarding the retention of capital within the borrower does not clarify whether distributions can be made by the borrower as long as the 15% minimum capital requirement continues to be satisfied. The reference to the continued retention requirement with respect to internally generated capital in the regulatory guidance would seem to indicate that such distributions are not permitted.

In recent years, many institutional investors have required their developer partners to make cash equity investments in projects being developed. Often, however, investors have been willing to let developers defer at least a portion of their cash equity investments to coincide with the payment of fees which the developers will receive during the course of developing and constructing the projects. Some construction lenders have declined to permit such deferred contributions to be made by developers, possibly because of concerns that such deferred contributions are in conflict with the HVCRE 15% front-end equity requirement. Other lenders have questioned whether such deferred contributions are permitted under the HVCRE 15% front-end equity requirement but have been willing to allow them when it was pointed out that, due to a 25-35% traditional equity requirement for the loan, the actual front-end cash contributions by the investor and the developer would be well in excess of the HVCRE 15% requirement even if the developer's deferred contributions are totally disregarded.

Although the new HVCRE requirements became effective as of January 1, 2015, loans in existence on that date are subject to these requirements as well as loans made thereafter.

D. Potential Trends in Real Estate Lending

Recent conversations regarding the possible terms and conditions of upcoming real estate lending transactions have indicated that several trends may be emerging to reflect some perception of increased risk in the market for commercial real estate development projects.

One trend which may be emerging is a reduction in the permissible loan-to-cost or loan-to-value ratios for construction loans. Speculation is being given to ratios as low as 50%. A corresponding potential trend involves the idea of obtaining the increased remaining funds needed for projects from a combination of mezzanine loans and conventional equity, rather than attempting to obtain all of those funds from conventional equity.

If the use of mezzanine loans becomes prevalent, then we will all need to revisit the mezzanine lender-borrower issues and documents and construction lender-mezzanine lender issues and documents we considered and negotiated at such length in earlier lending cycles. Those issues will include, but certainly not be limited to, provisions for the mezzanine lender to make additional financing available in some form to defray operating deficits and provisions for coordination between the construction lender and the mezzanine lender in bankruptcy proceedings involving the borrower.

IV. CONCLUSION

It is hoped that the foregoing discussion will be of assistance to the members of the audience in analyzing and dealing with these and similar issues in connection with their own transactions.