STUDY OUTLINE

1. **Introduction.** The comments which follow have been prepared with an emphasis on the perspective of the developer and the developer's attorney. Notwithstanding the length of the publication, it is not an exhaustive treatment of the subjects which are addressed. Not all of the subjects which are covered by the following materials will be included in the faculty discussions; the materials are published to provide a survey of activities applicable to real estate transactions against which specific areas can be explored. The materials reflect a pragmatic and not a scholarly approach to the subject matter.

2. **Project Chronology.** One means of understanding the various segments of a commercial project is to place the component parts in the chronological sequence in which they customarily occur.

   2.1 **Planning; Feasibility.** The development of a project ordinarily encompasses a number of separate undertakings which might be pursued simultaneously or in tandem, but all of which must combine to produce success. All of those undertakings are brought together and the project is generally considered to be feasible when commitments for financing are issued to the developer.
2.1.1 **Land Acquisition.** The first cost of the project is fixed at the time of acquisition of the land. The true cost of land to the developer is not the per acre or per square foot cost, but the total cost to bring the land to the point of consumption. That cost customarily includes raw land cost, the cost of providing utility and other governmental services to the land, the costs of obtaining zoning, use and environmental approvals, the cost of creating access to and within the development, the cost of curing title defects and the interest expense or return on investment charged to the carrying period prior to development. To the extent that those costs can be minimized or shifted to the seller of the land, the developer can create substantial savings and reduce the risks of development. In an effort to minimize risk and carrying cost, the developer might enter into an option agreement or purchase contract with the landowner setting forth the conditions precedent to the developer's obligation to purchase (or forfeit option or earnest money deposits), which conditions precedent will generally include: (a) approval of title as suitable to the development; (b) approval of zoning and other use restrictions; (c) approval of engineering reports as to soil conditions, drainage, flood plain designations and the absence of hazardous or toxic substances; (d) availability of utilities in adequate capacities and appropriate costs to service the development; (e) availability of pedestrian and vehicular access ways; (f) obtaining of environmental permits and other approvals of governmental agencies; (g) acceptability to the developer of the costs of rendering the land ready to develop; and (h) any other peculiarities of the land which must be resolved prior to the final decision to proceed with development. It should always be noted that the acquisition of the land offers the first significant opportunity for leverage by use of a purchase money loan, a long term ground lease or a joint venture arrangement with the landowner. The use of those financing devices must be coupled with appropriate provisions which will enable the developer to discharge or modify the terms of the purchase money financing to facilitate later financing and marketing of the development.

2.1.2 **Market Studies.** Every project begins with a market study. The magnitude of that study might range from the visceral reaction of the developer to a comprehensive analyses prepared at great expense over a substantial period of time. The nature of the study is ordinarily dictated by the number of parties other than the developer who must be convinced as to the economic viability, desirability and probability of success of the proposed project. The market study should produce preliminary estimates of the cost of the project, its marketability, the impact of the geographic location, the presence of local impediments to development, a timetable for development and the identification of the personnel required to supplement the developer's personal efforts.
2.1.3 **Project Design.** The timing of the design of the project usually depends on the confidence that the developer has in the project, the peculiarities of the site or the project, the extent to which reliable cost estimates are required, the procedure which will be used to produce final plans and specifications and the perceived requirements of the lenders or end users which are anticipated to be involved in the project. At a minimum, the developer must preliminarily define the use of the land, the extent of subdivision, the number and/or size of the improvements, the general appearance and amenities to be incorporated in the project and the timetable and cost to produce final plans and specifications.

2.1.4 **Cost Estimates.** At the preliminary stage the developer generally relies on the developer's prior experience with similar projects and "guesstimates" of third parties with respect to the cost and resale value of the project. As the feasibility study proceeds, the cost estimate will be polished by the use of bids and negotiated contract amounts so that the fixed costs and contingencies of the project can be defined in a reliable estimate appropriate for submission to lenders.

2.1.5 **Selection of Owning Entity.** Prior to the passage of the Internal Revenue Code of 1986, the nature of the entity which owned the project was in large measure dictated by the tax treatment which the developer wished to obtain. Although the current tax law deemphasizes the importance of entity selection, the tax treatment the development would yield remains an important consideration. Apart from tax planning, there are a number of nontax considerations which are of importance in selecting the ownership vehicle. The vesting of title to the project in a fictitious entity (whether a trust, corporation, partnership or limited liability company) will provide a vehicle to permit continuity of ownership, divisibility of ownership interests, creation of subordinate equity financing devices, limitation of liability and insulation of a project from claims of the developer's creditors. For those reasons, many commercial projects are owned by fictitious entities created by the developer to own only one project. The documents creating the owning entity should contain provisions dealing with initial and additional equity contributions or advancements (with remedies specified in the event of a member's failure to fund), restrictions on transfer of ownership interests, rights to indemnification, contribution and restitution among the members of the owning entity and buy-sell arrangements operative in the event of the bankruptcy, death or default of the members. The documents creating the owning entity will be the subject of scrutiny by lenders advancing funds for the project and, in the event of default, the legal sufficiency of the entity will ordinarily be tested by its creditors. The entity should be
correctly and completely formulated at the inception of the project and operated as an independent entity by the developer. The developer's ultimate basis for selecting the owning entity must involve a careful determination of whether the developer will ultimately seek to maximize ownership or reduce risk by sharing ownership of the project with a codeveloper, financial partner or end user. That decision is made based on the developer's financial strength, time availability, expertise with similar projects and risk analysis.

2.2 Financing Commitments. One of the first contacts made by the developer (usually prior to serious negotiations to acquire the land) will be the developer's existing lenders. The developer will usually discuss the project at some length to obtain the lenders' advice (or on the pretense of obtaining the lenders' advice) and a preliminary indication as to the lenders' willingness to extend credit in connection with the project. One of the developer's unspoken purposes in the discussions is to generate a personal involvement by the lending officer in the evolution of the project so that the officer can represent the project in future deliberations by the officer's institution. This courtship will continue during the feasibility period until it ripens into the issuance of written commitments to the developer for the extension of construction and term loans to finance the project.

2.2.1 Term Financing. After the developer has completed the feasibility studies, made arrangements to acquire the land, created (or at least designated) the owning entity and obtained preliminary plans and specifications, the developer is ready to apply for term financing which will amortize the cost of the project over a period which might range from five to forty years. That financing is customarily provided by insurance companies, savings associations, savings banks, pension funds, real estate investment trusts, foreign investors and various agencies of local, state and federal governments. The availability of financing is evidenced by the issuance of the lender's written commitment setting forth the terms of the financing arrangement and the requirements which the developer must satisfy as conditions precedent to the lender's obligation to disburse funds under the commitment.
2.2.2 Construction Financing. After the developer has obtained a commitment for term financing, and has formalized the feasibility studies, land acquisition agreements and the estimate of the cost to produce the project, the developer will approach a commercial bank or savings institution to obtain construction or interim financing pending funding under the term financing commitments. The lending considerations of the interim lender are substantially different from those of the term lender. The interim lender is primarily concerned with (and the lender's major risk centers around) the ability of the developer to complete the project within the dollar limitations imposed by the funds available under the term financing commitment and the assets dedicated by the developer to the project. The repayment of the construction loan necessarily requires the satisfaction of the term lender's conditions precedent to disbursement and the collateral requirements of the construction lender are accordingly directed to the continued personal involvement (by means of personal liability) of the developer and the assembly in the hands of the construction lender of collateral rights covering all of the property interests associated with the project. In theory, the construction lender should be placed in a position so that a default by the developer will enable the construction lender to foreclose and fulfill the requirements of the term lender thereby forcing funding under the term financing commitment to retire the construction loan.

2.2.3 Combined Financing. The current financial difficulties experienced by traditional institutional lenders and the prior entry into the market of less experienced real estate lenders (now in the hands of the Resolution Trust Corporation or Federal Deposit Insurance Corporation) have lead to the creation of a combined form of financing commonly referred to as a "mini-perm" loan. In many areas of the country, the mini-perm has become the usual form of financing given the fact that traditional term lenders have been unwilling to issue forward-financing commitments. Using this device, a single lender funds the construction loan followed by a relatively short term loan which is either standing (without amortization) or which calls for principal amortization using a 20 to 25 year schedule with a balloon maturity three to five years after the completion of construction (this portion of the financing is often called a "bullet loan" for obvious reasons in current financing markets). While this device has provided significant fee income for many lenders and has fostered continuing development, it has two major shortcomings. Under the traditional structure of separate construction and term lenders, the feasibility of the project was subjected to at least two different sets of underwriters, one of which was concerned with the cost to produce the project and the second of which was primarily concerned with longer term
operation and marketing. That diversity of focus sometimes contributed to the success of a project by imposing stricter requirements than a single underwriter might have made. The second difficulty with the mini-perm philosophy is the requirement that the unamortized portion of the term loan be refinanced or renewed at maturity. Currently maturing mini-perm loans have presented significant problems for both developers and lenders because it was the intent of neither that the lender would enter into serial renewals of the loan at maturity and, given the level of financial institution failures in the last ten years, many of the mini-perm loans have ended up in the hands of the liquidators or their successors. Given the continuing uncertainties in real estate markets throughout the country, one wonders whether it is a prudent decision to enter into a relatively short term transaction as either a lender or a borrower on the assumption that financing markets will improve prior to the maturity of the mini-perm loan thereby allowing the lender to regain liquidity and the developer to refinance at favorable interest rates.

2.3 Production. If the developer's timing is good, the developer will simultaneously close the construction loan, fund the land acquisition, accept the commitment of the term lender and finalize the construction contracts. Thereafter, the project proceeds to realization by means of periodic disbursements of the construction loan proceeds to pay the costs of building the project. During the course of constructing the project, the developer will perform the marketing functions which are required to satisfy the conditions of the term financing commitment which serves as the primary basis for repayment of the construction loan. Those marketing efforts might include the leasing of space or the presale of subdivided parts of the project pending completion of construction.

2.3.1 Architectural/Engineering Contracts. As a part of the feasibility stage, the developer will have retained the services of architects and/or engineers to provide site plans and preliminary plans and specifications. Those preliminary arrangements are now reduced to formal agreements, the terms of which will be dictated by the peculiarities of the site, the project, the lenders and the developer. The contractual arrangements and costs of the services vary widely from project to project, but the basic documentary forms customarily follow those promulgated by the American Institute of Architects ("AIA").

2.3.2 Construction Contracts. After the initial expression of interest by the lenders involved in the project, the developer will customarily begin the negotiation of construction contracts. The project might involve the use of a single general contractor, a series of multiple general contractors, the developer acting as "general contractor," a design-build contractor, a construction manager or various combinations of the foregoing

Modern Real Estate Transactions, July 2006
compensated at a percentage or fixed fee with a guaranteed maximum price or on "cost plus" basis. The project might be let for bids, privately negotiated or both. The performance of the contractors' and/or subcontractors' obligations might be bonded, secured by other collateral or unsecured. The device selected is ordinarily a function of the developer's preference, the size of the project, the availability of work and the requirements of the lenders. In any event, the AIA documents will almost always be used by one or more of the parties and those documents should be carefully adapted to the laws of the jurisdiction, the project and the client's interests.

2.3.3 Marketing. During the course of constructing the project the developer will exert significant marketing efforts to assure that the units are sold or the project is leased at the earliest possible date to maximize the realization of income and offset the interest expense associated with the project. The developer's attorney will prepare letters of intent, contracts of sale and occupancy leases conditioned on completion and delivery of the project. In most cases the developer is overly optimistic, the contractor is delayed and the end user is impatient.

2.4 Completion. If the developer's marketing program is successful and the conditions precedent to funding under the term financing commitment are satisfied, construction of the project will be completed in close proximity to occupancy by tenants or sale to consumers. The proceeds of funding under the term financing commitment will be realized by the developer and applied to the costs incurred in producing the project which are customarily represented in large part by the unpaid balance of the construction loan.

2.4.1 Term Financing. Term financing devices are discussed elsewhere at some length. In summary, the closing of the term financing generally requires: (a) the execution and delivery of the term loan documents (or the assignment of all or a part of the loan documents held by the construction lender, if the term loan has been "pre-closed"); (b) the issuance of a policy of title insurance without exceptions for mechanics', materialmen's and laborers' liens; (c) the delivery of a final survey and architect's certificate; (d) the approval of lease agreements and delivery of tenant estoppel certificates; and (e) the delivery of assurance of the developer's authority to consummate the term financing. Thereafter, the developer amortizes the term financing from the income stream of the project. Where the term financing structure involves alternative devices such as sale-leaseback arrangements, joint ventures or other risk-reward allocation mechanisms, the foregoing will be overlaid with substantial additional requirements.
2.4.2 Lease/Sale Closings. Some projects such as tract developments, condominium projects, public housing projects and single user buildings are developed for sale immediately after completion of construction and the sale proceeds are used to retire the construction financing. In those cases, there will be a single or multiple sale closings and the developer will be faced with satisfying the conditions precedent to closing imposed by the purchaser and by the lender extending financing to the purchaser. In other projects such as apartment, shopping center, office and industrial properties, the closing will surround the execution of lease agreements and the occupancy of the project by primary tenants designated by the term lender or by a rental achievement based on a percentage of occupancy and minimum rental rates specified by the term lender.

2.4.3 Operating Contracts. Depending on the nature of the project, the contracts associated with operation might be very simple or very complex. Perhaps the most complex examples involve development of industrial sites where matters such as fire protection, liquid and solid waste disposal, rail service, extraordinary electrical, gas and water supplies are required. The creation of a subdivided regional shopping center with multiple land locked store pads and peripheral out parcels creates significant operating relationships and reciprocal easement burdens and benefits which must be carefully crafted. The organization of the homeowners’ association in a major condominium development or umbrella associations in major planned unit developments are often complex, time consuming and frustrating. Management of many projects is independently contracted and the management and leasing agreements become basic documents involved in real estate transactions; in certain instances the management agreements are used as financing devices. Likewise, the broker lurks at every corner seeking to be compensated for plying his trade.

2.4.4 Project Sale. In order to ultimately realize the maximum financial benefit from a project, at some point the developer must sell. Because real estate markets are cyclical and because most projects are highly leveraged, the timing of the sale is absolutely critical. If unit sales or occupancy rates collapse, the value of the project evaporates and the carrying expenses of the project create massive cash requirements to fund negative cash flow. Timing of a sale is more a matter of intuition than analysis. Because of the importance of sale transactions and the virtually uniform involvement of attorneys by the parties, a significant amount of time is spent elsewhere in these Course Materials addressing the issues which are involved.

3. Parties. Another introductory approach toward real estate transactions is to identify the characters (the term is used in both its literal and figurative sense) which are commonly involved. As with any other commercial transaction, it helps to have a