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The Impact of Clashing Interests and Agendas on Real Estate Transactions

SEPTEMBER 2016 | REAL ESTATE

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Competing interests continue to drive the direction of real estate development and finance in the US. Governmental regulation (interference, some might say) following the 2008 global recession has added to the complexity of real estate finance structuring as the governmental (and public) interests collide with the interests of financial institutions. The intersection of governmental development and fundraising goals, private development interests and neighbourhood concerns have often clashed prior to a consensus on sensible development being reached.

The New World of Real Estate Finance

The global recession almost caused the collapse of the international banking system. One should not have been surprised that something was amiss when, upon waking in the morning and turning on the radio, there was an incessant drumbeat of lenders offering residential loans up to 125 per cent of property value, loans ultimately packaged in securitised trusts and peddled to "unsuspecting" investors who thought they were acquiring investment-grade securities. There was little difference in the commercial loan sector. So the collapse in values, with borrowers unable to keep up with debt service requirements, appears inevitable in retrospect – as do the lawsuits from investors (mostly financial institutions) claiming to have been duped into investing.

Conflicting Incentives for Capital Access in Development Deals

The 2008 global recession and its aftermath resulted in the regulatory reforms imposed by the US Dodd-Frank legislation, as well as the Basel III international framework of reforms for banks. Each was designed to mitigate, if not prevent, the serious shock to the worldwide banking system that resulted from the "bad" loans and "poorly backed" securitised trust investments. In July 2013, US federal banking authorities released the final rules designed to implement tighter capital rules associated with so-called high-volatility commercial real estate (HVCRE) loans. In essence, in the context of construction loans, the rules effectively place a heightened premium on capital structures with significant borrower equity (15 per cent of the appraised "as completed" value of the underlying project). With the enactment of these new rules, federal regulators have further clarified that the capital requirements cannot be met by secondary or junior priority loans to the same borrower – equity is required. The theory behind these regulatory controls is that the US banking system – and therefore FDIC-insured institutions – would be less exposed to the impact of defaulting loans as the result of implementation of rules making development loans (as opposed to more favoured loans, such as Small

Business Administration loans) a less desirable form of capital investment for banks, and requiring that borrowers have more "skin in the game."

The impact of Dodd-Frank and Basil III on the financial interests of financial institutions, and the development interests of developers, cannot be understated. Some have even argued that some of the regulatory reforms may have gone too far and conflicted with the interest in making sufficient credit available to generate economic activity. The perhaps unintended consequence of the regulations has been to increase the cost of development and limit its availability, adding to the complexity of capital structures. Regional banks and credit unions have found compliance too difficult and expensive, and many have exited the real estate lending market leaving fewer, more expensive, choices for credit. To avoid being regulated as a "systemically important financial institution", several major institutions such as GE Capital have exited the market or sold valuable business lines. Efforts are ongoing in the US Congress to revise the Dodd-Frank regulatory regime to, at the very least, provide some relief to the smaller community and regional banks, and perhaps more. We will see what the coming election brings.

Beyond access to capital, there is the concern that regulators have dismissed the implications of the degree to which real estate, and in particular, real estate finance, is much more of a global industry. This reality has not come about overnight, as evidenced by the ability and interest of developers seeking to access Wall Street capital through commercial and residential mortgage-backed securities (CMBS and RMBS) and other means. No question, the governmental agendas that resulted in the enactment of the financial reforms of Dodd-Frank, Basil III and various consumer protection statutes have had an impact on transactional structures and developmental velocity. However, even though participants are increasingly faced with the challenges of implementing or responding to macro-politically inspired guidelines and regulatory reforms, the end result, based on experience, is to complicate real estate lending and development activities, rather than to encourage more prudence in such activities. In particular, at this point in the economic cycle, the new guidelines for US banks appear at odds with other federal agendas (specifically the EB-5 investment programme), local development agendas and funds for new green and urban development. One result has been the creation of several debt funds (sometimes called unregulated "shadow banks") willing to step into the capital structures, in each instance affording unique and more cost-effective capital than can be provided by heavily regulated financial institutions. Ultimately, developers will always seek the cheapest cost of capital, even if it results in overly complicated capital structures.

Post-Regulatory Capital Structures

As noted above, regulatory reforms have resulted in the requirement that developers have more equity in a development project. Loan-to-value ratios have been reduced. Recourse, at least with respect to construction completion, has returned to construction lending. Underwriting is stricter.

Unfortunately, regulators drew somewhat arbitrary lines by prohibiting certain kinds of investments from counting as "equity". For example, regulators appropriately prohibited junior secured debt – a particularly common form of financing of single-family residential development financing, but not a common form of financing in commercial development, where mortgage lender debt recovery concerns in a bankruptcy proceeding involving multiple secured creditors eliminated junior real estate secured loans as a feature in commercial development capital structures. Even before the recession, mezzanine debt, secured by ownership interests in a borrower, had taken hold as an efficient and valuable piece of the capital stack with risk appropriately priced. However, the regulators determined that mezzanine debt from a third-party provider does not count as equity, though the economically

similar preferred equity could so count. As a result, some debt funds have merely restructured their investment programmes (raising the question of whether the distinctions really accomplish anything), and some mezzanine debt providers have exited the market, raising the cost of capital. Ultimately, in some instances, in order to raise sufficient capital and still meet the 15 per cent equity test, borrowers have obtained both mezzanine debt and preferred equity, thereby satisfying the regulatory requirement while having no more “skin in the game” than developers did before the implementation of the regulations.

Foreign Financing Investment

As non-institutional debt and equity will continue to play a leading role in real estate lending, EB-5 capital is a much-sought-after component of today’s development transactions. Simply stated, the EB-5 programme, accommodating the interests of the immigration and investment communities, offers a limited number of immigration visas on the basis of economic investment in commercial enterprises. The EB-5 programme was actually passed in the US in 1990 as a way to stimulate the economy and, in particular, employment in economically disadvantaged locations. However, with the capital tightening during the global recession, and developers seeking alternative sources of capital, the boundaries of the “disadvantaged locations” grew. EB-5 capital became available for development projects in upper-class neighbourhoods to the advantage of developers’ interests, but not to the public interest. In any event, despite the controversy, according to the US Citizenship and Immigration Services (as reported by Invest in the USA, a not-for-profit industry trade association for the EB-5 Regional Center programme), annual investment of EB-5 exploded from US$320 million in 2008 to US$4.38 billion in 2015; total investment during that time has been in excess of US$13 billion.

The public interest in expanding EB-5 investment is ironically intertwined with regulatory efforts to tighten the availability of bank capital for development deals. The cost of EB-5 capital is typically so low when compared to that available from debt funds, that it is very attractive to developers. However, in order to fit within the structures required by the HVCRE rules, EB-5 investment is pushed into either a preferred equity or, where a developer otherwise has the required 15 per cent capital invested, a mezzanine lending structure. In both instances, senior lenders are becoming more concerned about the execution of EB-5 syndicators successfully raising funds and often require changes to their loan structures in order to permit and monitor the capital investment by the EB-5 facilitator. It is not uncommon for the complexity and cost to be even greater than “traditional” mezzanine and preferred equity structures.

What is perhaps more troubling is the absence of a proactive regulatory environment that anticipates EB-5 investment. Certainly, the new HVCRE rules have succeeded in increasing the financial equity investment of a developer, making it less likely a developer will abandon a project mid-construction. However, the EB-5 rules are effectively forcing a marriage of these same developers with investors who may not have pockets sufficiently deep to contribute additional capital if a project becomes troubled, the economy falters or demographics underlying the construction project change. Simply put, by encouraging developers to align themselves with EB-5 investors in unanticipated ways creates a risk that the incentives being fostered by Dodd-Frank and Basel III will be undermined.

Unfortunately, rather than the US Congress seeking to better align the capital investment rules of EB-5 with the financial reform acts of Dodd Frank and Basel III, current efforts to improve EB-5 investments appear directed at securities compliance and solicitation – but not (as alternative or in addition) requiring that EB-5 investors be willing and able to make additional capital calls in the face of a financial downturn.

Competing Interests in Development – Stadium and Arena Dreams

At the recent American College of Real Estate Lawyers meeting, the kick-off panel debated stadium and arena development and the competing interests that must be satisfied to bring a project to fruition. Reviewing the successes (enhanced ancillary real estate development offsetting the public investment) and failures (poorly located projects resulting in continuing public subsidies), the panel concluded that success was site- and design-specific and that there was no one-size-fits-all solution. Downtown locations have potential built-in advantages with walkability and public transportation options, yet for many sports-team owners the ability to control surrounding property and create an integrated real estate environment is a significant motivator. Certainly, the civic desire to support a sports team for intangible community benefits can override the financial investment risks involving public funds, all for the financial benefit of team owners.

Yet, if well thought out and vetted, a stadium/arena project can foster surrounding development, benefiting the community and increasing property values (and, therefore, property taxes to be added to the public coffers). The recent battle in Los Angeles for the return of the Rams football team resulted in the team's move from St Louis to a new stadium being built on the site of Hollywood Park, a former horse-racing facility in Inglewood, California. The stadium will be the centerpiece of an enormous mixed-use development of 3,000 residential units, 600,000 square feet of retail, a luxury hotel, and the West Coast home of the National Football League. Real estate developers smelling an opportunity have been buying up properties in surrounding neighbourhoods in anticipation of a bright development future.

And the same story is playing out around the United States. Washington, DC has witnessed stadium and arena developments in not-so-nice areas of the city, serving to jump-start adjacent real estate development in a meaningful way. Minneapolis-St Paul has seen no less than five major stadium and arena projects brought into development, fostering transit connections all across the Twin Cities and two 18-storey office towers for Wells Fargo near the new Vikings Stadium. San Jose, Sacramento, suburban Atlanta and other cities have all confronted and debated the impact of new stadium and arena development and reached consensus.

The Detroit Miracle

But nothing exemplifies the potential impact of an arena development than plans for a new home for the Detroit Red Wings hockey team. In 2011, a *Who's Who Legal: Real Estate* article ("Opportunity from the Ashes of a Real Estate Meltdown") posited the potential ability of cities such as Detroit, with blocks of abandoned housing and commercial buildings, to aggregate these properties for a well-planned public/private partnership to reverse the decline of the inner city. Led by the Red Wings' desire to build a new arena, Detroit has aggregated an approximately 50-block, 50-acre site for the arena and a new entertainment district development called "the District Detroit", featuring space for businesses, parks, restaurants, bars, housing and retail – and, not insignificantly, the Wayne State University Mike Ilitch School of Business, made possible by a $40 million donation from the Red Wings' owner. Given the fiscal problems that have confronted Detroit, this project represents a major triumph of the balancing of public/private interests. And once redevelopment starts, others are encouraged – as shown by the development of the recently announced downtown Detroit Paradise Valley Cultural and Entertainment District, in a historic African-American neighbourhood.

Public/Private Interests in Transit-Oriented Development

Transit-oriented development has been a watchword for many years now. It takes a great deal of effort for transit projects to come to fruition, given the historic underestimating of project costs. But once a transit project proceeds, then developers, the governing authority and neighbourhoods adjacent to transit project stations can plan, negotiate and develop real estate projects designed to accommodate the competing interests. The governing authority, often a collection of public officials from the municipalities most affected by transit projects, envision a return on the investment that can result from a public/private partnership for development (typically a lease by the governing authority of land surrounding transit stations to a developer) and the increased property tax revenues resulting from increased property values adjacent to the project, and particularly the stations. Neighbourhood activists, particularly in lower socio-economic areas, are concerned about and will fight gentrification, higher rents and the resultant supplanting of lower-income residents – interests that need to be accommodated. Obviously a developer needs to make a profit on a project.

Transit-oriented development projects require a shared vision, which is not often easy to attain. Diverse communities want to remain diverse, yet some level of gentrification will benefit all who stay. Inclusionary housing policies – affordable housing requirements – balanced by economic benefits offered to developers can make a difference. Land-use controls mandating a variety of mixed uses to benefit the community can be added to the mix. Employment requirements, such as hiring goals, living wages and so on can result in community support. Reaching consensus is not an easy task – as shown, for example, in the recent community opposition to a proposal for a 30-storey tower adjacent to a forthcoming Los Angeles light-rail station, in a location currently devoid of any similar building. Lawyers will be dealing with competing interests in transit-oriented development for a long time.

The Problem of Public Subsidies

There are other aspects of competing interests that seem to be ever-present. To what extent should public subsidies be granted to encourage development, with the debate concerning whether a development would occur without the subsidy? This is a major issue in stadium/arena projects, as well as other projects where the governing authorities conclude that public benefits outweigh the subsidy. In California, the Anaheim City Council recently granted $550 million in tax incentives over a 20-year period to the Walt Disney Company to foster the development of a luxury hotel, a grant that has generated considerable controversy about the proper spending of public funds.

Neighbourhood Backlash

When is enough development enough development? The improving economy and low-interest-rate environment accelerated projects that had been on the drawing board for some time. As the projects all have moved forward somewhat simultaneously, the risk of backlash by neighbourhoods overwhelmed by the development has become a factor. Local initiatives such as the Neighborhood Integrity Initiative in Los Angeles, designed to restrict zoning variances and other exceptions to existing land use regulations, will likely be on the ballot in 2017, which will certainly cause a major clash of developer and neighbourhood interests.

At the End of the Day

Ultimately, lenders, investors and developers are interested in profit. The US federal government is interested in encouraging certain types of development (eg, affordable housing) and protecting public and private funds. State and local governments have a similar interest in encouraging certain types of development, but also in protecting neighbourhoods from the impacts of development. The end result

of these competing interests changes over time, and, all too often the consensus serves to add to the complexity of financing and development structures, increasing transaction costs, creating hurdles to development, but also fostering opportunity to those who can nimbly react to a changing environment. Whether or not a more consistent regulatory structure at the national level is forthcoming remains to be seen. Developers and lenders will continue to face a diverse spectrum of political agendas that will shape their options and likely complicate access to capital and capital structures.

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