

THE TEN STAGES OF A REAL ESTATE DEVELOPMENT PROJECT



J. RICK DALEY is a retired Senior Lecturer in Law who taught at The Ohio State University Moritz College of Law. Rick is the author of *Real Estate Development Law*, a treatise published by West Publishing as part of its American Casebook series. He joined the faculty of The Ohio State University Moritz College of Law in 2006, where he developed and taught two upper-level courses new to the College's curriculum: one on real estate development law and one on commercial leasing. Before joining the faculty at the Moritz College of Law, Rick practiced transactional business law for 28 years. During his years of law firm practice, Rick represented a wide variety of closely held corporate clients, with a special emphasis on the representation of real estate developers.

Many books and articles have been written about the various elements and stages of a real estate development project. Most of those works are written from the perspective of the real estate developer, so they are heavily weighted toward the stages of a project's life cycle having to do with the developer's formulation of its initial vision and its subsequent testing of that vision to determine the feasibility of moving forward with the development project. The vision and feasibility stages of the real estate development process are uniquely the province of the developer as entrepreneur and visionary. The lawyer (almost by definition, neither a visionary nor an entrepreneur) rarely plays anything but a minor, peripheral role in these initial two stages of the real estate development process. The lawyer's role starts once the developer client has come up with its initial idea for the project and reached at least a preliminary conclusion about the project's feasibility.

From the perspective of the real estate development lawyer, the 10 stages of a real estate development project are as follows:

1. Gaining control of the site;
2. Securing essential governmental approvals and incentives;
3. Forming and capitalizing the project entity;
4. Closing the land acquisition;
5. Securing construction financing;
6. Designing and constructing the project;
7. Negotiating the project lease;
8. Executing an interim exit strategy;
9. Operating the project; and
10. Selling the project.

These 10 stages are present, in some fashion, in every real estate project. They do not, however, occur in any neat, sequential order. It is a rare deal indeed in which at least three of the stages do not converge and play themselves out over exactly the same period of time. By way of example, it is far from unusual for the real estate development lawyer to be negotiating a contract with a landowner seeking control of the site at the exact same time he is negotiating a construction loan commitment with a bank and the specifics of a tax abatement package with representatives of the local municipality.

This article will examine in summary fashion the lawyer's perspective on each of the 10 stages of a real estate development project. That examination will first focus on the developer's business objectives and then will move on to a discussion of the lawyer's activities in support of those business objectives.

STAGE 1: GAINING CONTROL OF THE SITE

Developer's business objectives

It is assumed for the purposes of this article that the developer has already selected a site that it believes is an ideal (or at least acceptable) location for the creation of a project to satisfy the needs of its targeted customer. Once that site is selected, the developer's

business objective is to gain control of that site as quickly and cheaply as possible.

It is quite likely at this stage of the project's life that the developer has made only a preliminary decision on the feasibility of the project. While the developer probably feels pretty good about the location of the site, the developer has likely not yet worked out the final project economics, secured debt or equity financing, or actually locked down a customer for the project. All it knows is that the project has potential if it is located on the selected site. The developer's goal at this stage of the game is simply to tie up the site long enough to permit the developer to do all those things that are necessary to permit it to reach a final conclusion on whether the project is a "go" or a "no go." All the developer has in mind when he tells the lawyer to "tie up" the site is the taking of whatever minimal actions are required to prevent its competitors from swooping in to gain control of the land and, therefore, the project's potential.

Lawyer's job

This is the stage at which the real estate development lawyer has the first opportunity to add value to the client's project. The lawyer's activities during this stage are as follows.

Learn the business deal

Before putting pen to paper (or, in today's world, fingers to keyboard), the real estate development lawyer must first acquire a solid working knowledge of all aspects of the client's project, including the project's targeted customer, product type, financial projections, and development schedule.

Prepare the "what if" list

This is where the lawyer's value-add shines at its brightest. It falls to the real estate development lawyer to go through the mental gymnastics of identifying all those foreseeable events and conditions, the occurrence or existence of which could lead the developer to decide to scrap the project. These are what my first mentor called "what ifs"—what if the land is not zoned for commercial development,

what if hazardous substances are found on the site, what if title to the land is unmarketable, etc. Once those what ifs are identified, the lawyer must then figure out how best to protect the client from their occurrence by either: (i) identifying a method to confirm their non-existence in the subject project (for example, by requiring the receipt of a clean environmental report certifying that no adverse environmental condition exists on the land); or (ii) providing an acceptable exit strategy for the client if the what ifs are found to exist in the project (for example, the grant to the developer of a right to terminate its obligation to purchase the land if an adverse environmental condition is found to exist on the land).

Select the right form of contract

Purchase agreements are a lot like clothing, in that there is no universal agreement about what is right for every occasion. Just as one would not wear flannel pajamas to a wedding, the real estate development lawyer should not use a 100-page, killer form purchase agreement to paper the client's purchase of a two-acre tract from an unsophisticated farmer.

Prepare and negotiate a contract that serves the client's objective

In preparing the purchase contract, the real estate development lawyer must always keep in mind what the client's business objective is at this stage of the project—that is, to gain legal control of the land long enough to permit the developer to figure out if the project is feasible. Preparing a contract that serves this business objective, while at the same time protecting the client from the existence of the dreaded what ifs, is an art form that must be mastered by any lawyer who aspires to success in the real estate development field.

STAGE 2: SECURING GOVERNMENTAL APPROVALS AND INCENTIVES

Developer's business objectives

Before the developer purchases the land, it wants to have in hand all those governmental approvals that

are essential to the developer's decision to move forward with the development of the project. The identity of the "essential" governmental approvals will vary from deal to deal, depending on the uniqueness of the deal and the political climate in the jurisdiction where the project is situated. At the bare minimum, the developer will want to know that the property is zoned to permit its development in the contemplated manner and that any governmental incentives needed to make the project's economics work are in place (for example, the grant of a tax abatement or the government's agreement to fund the construction of needed off-site infrastructure). In an ideal world, the developer will have received all requisite governmental approvals prior to its purchase of the land (culminating in the issuance of a building permit for the full construction of the project). However, the real estate developer does not live in an ideal world and is almost always willing to proceed with the land purchase before its receipt of those governmental approvals that are either perfunctory in nature or that the developer's experience tells it will eventually be issued without any controversy or unreasonable delay.

Lawyer's job

This is the one stage at which the extent of the real estate development lawyer's participation can vary a great deal from project to project. The real estate development lawyer must first sit down with the developer client to determine which governmental approvals fall into the "essential" category mentioned above. It is quite common for the developer to take the lead in securing those governmental approvals, which, while essential to the project, are not perceived to be the subject of much political controversy. Unfortunately, in today's politically divisive atmosphere, very few governmental actions fall into the "uncontroversial" category. It is the real estate development lawyer's job to be sufficiently well-versed in the legal parameters surrounding the sought-after governmental approval, so that he or she can come to the client's rescue if and when things get sticky. To the extent things get really sticky (for example, if the developer wants to build a Walmart superstore adjacent to a high-end

residential subdivision), the developer should strongly consider bringing in political muscle in the form of separate zoning counsel, who can leverage his or her relationship with the local politicians to secure the desired approval.

STAGE 3: FORMING AND CAPITALIZING THE PROJECT ENTITY

Developer's business objectives

Few developers profess to be experts when it comes to structuring either the entity that will own the project or the manner in which any outside equity investors will participate in that entity. Developers do, however, have some very specific expectations (some might say "demands") as to the outcome of that structuring:

- The structure must be "tax-efficient" (lawyer-speak for the developer's desire to maximize its profits, while minimizing the tax it pays on those profits);
- The structure must limit the developer's personal liability for project risks;
- The structure must vest as much decision-making control as possible with the developer (developers give whole new meaning to the term "control freak"); and
- The structure must result in any investment by outside equity providers being "cheap capital" (meaning that the financial return paid to the outside equity providers is as low as possible and, in all events, less than the aggregate, percentage return that will be paid to the developer if the project proves to be as successful as originally projected).

Lawyer's job

This is the project stage where the development lawyer gets the chance to truly showcase the breadth of his or her legal knowledge. The lawyer is much more a tax, securities, corporate, and partnership lawyer during this stage than a real estate lawyer. It is this project stage, more than any other, that demands that the development lawyer have a

full and effective understanding of the economics of the subject real estate project. The development lawyer must first select the proper form of the legal entity that will own the project. The lawyer must then draft legal documents to govern (i) the manner in which the entity is capitalized and managed, and (ii) the way in which the project's profits and losses are allocated among the developer and its outside equity investors. In doing so, the development lawyer must be mindful at all times of meeting the aforementioned expectations of the developer client, no matter how unrealistic certain of those expectations may be. The real estate development lawyer must also seek to imbue the entity's governing documents with sufficient flexibility to cover the future twists and turns in the project's development and the maturation of the relationship among the developer and the equity investors. Designing appropriate exit strategies to deal with those twists and turns is one of the development lawyer's biggest challenges during this project stage.

STAGE 4: CLOSING THE LAND ACQUISITION

Developer's business objectives

The closing of the land acquisition is the watershed moment at which the developer effectively makes the decision to proceed with the project. Before it commits the funding necessary to acquire the land, the developer must have first reached a comfort level that the project is indeed feasible—that the rewards of moving forward with the project sufficiently outweigh the risks. Once the decision has been made that the project is feasible, it then becomes time for the developer to begin executing its development plan for the project. In most situations, that means closing on the purchase of the land and promptly beginning on-site construction of the project.

Lawyer's job

As the keeper of the aforementioned what if list, it is the real estate development lawyer's job to make sure that all of the conditions specified in the purchase contract have been met to the developer's reasonable satisfaction. These conditions include:

- The successful conclusion of all project due diligence;
- The determination that title to the land is marketable;
- The securing of all requisite governmental approvals for the project;
- The validation of all representations and warranties made in the contract by the land seller; and
- The occurrence of all other events and the existence of all other circumstances specifically identified in the purchase contract as conditions precedent to the developer's obligation to buy the land (with such conditions frequently including the developer's subjective determination that its proposed project is physically and economically feasible).

Once it has determined that all such contractual conditions have been satisfied, the real estate development lawyer must next turn his or her attention to orchestrating all of the moving parts and players that make up a real estate closing. Much of what a lawyer does in preparing for and then effecting the land acquisition closing is more logistical than legal in nature. The closing checklist, which itemizes all those things that have to be done and all those documents that have to be executed and delivered at or before closing, is the lawyer's best friend during the closing process. As one author so aptly put it when describing why clients turn over the closing process to their lawyers—"Lawyers are diligent, obsessive and careful." Joshua Stein, *A Practical Guide to Real Estate*, at 173 (2001). While these characteristics sometimes get in the way in one's personal life, they are the perfect skills for the real estate development lawyer to possess when serving as the coordinator of the closing process.

STAGE 5: OBTAINING CONSTRUCTION FINANCING

Developer's business objectives

Historically, most developers have tried to fund somewhere between 70-90 percent of their development costs with construction debt obtained from a commercial bank or other financial institution. This

can vary depending on the prevailing economic conditions. For example, the percentage of development costs funded with debt dropped precipitously in the years following the Great Recession of 2008. The “new normal” is a moving target.

The developer wants to achieve four basic goals when securing construction financing for the project:

1. It wants the cost of the debt to be as cheap as possible;
2. It wants to be able to draw down on the construction loan when and as it needs to pay its bills;
3. It wants to make sure that it can pay all of its bills (including soft costs and fees payable to the developer) with debt and defer the use of its equity until as late in the process as possible; and
4. It wants to try to limit in some fashion its personal liability on the construction debt.

Lawyer’s job

The focus of the lawyer’s attention during the course of negotiating the construction loan documents should be threefold:

1. Addressing all those specific situations in which the funding needs of the developer’s project are at odds with the standard loan disbursement provisions of the documents (for example, the funding of the developer’s fees upfront and not pro rata over the construction term);
2. Trying to insert as much flexibility as reasonably practicable in the loan documents, so as to give the developer the ability to respond in an effective manner to unexpected developments during the construction period (for example, reserving the right to use cost savings in one category of construction expense to fund budget busts in another category); and
3. Including provisions in the loan documents that seek to limit the circumstances under which the developer will be personally liable for the

repayment of the loan (for example, providing that the loan will become partially non-recourse upon the leasing of some portion of the project to creditworthy tenants).

In performing his or her job at this project stage, it is imperative that the real estate development lawyer understand not only the business objectives of the developer client, but also those of the lender. If the lawyer understands the perspectives of both parties, he or she will be better able to successfully negotiate changes to the loan documents that serve the client’s interests, without eviscerating the legitimate business needs of the lender.

STAGE 6: DESIGNING AND CONSTRUCTING THE PROJECT

Developer’s business objectives

The developer wants to accomplish two basic goals during Stage 6:

1. The creation of a project design that is both aesthetically and functionally attractive to the developer’s targeted customers; and
2. The completion of project construction on budget and on time.

Achieving these two objectives requires the developer to be extremely hands-on during this stage of the project, meeting at least weekly with both the project architect and contractor to review the progress of construction and to prepare an action plan to address any unexpected developments.

Lawyer’s job

The task falls to the real estate development lawyer to prepare contracts with all of the design and construction professionals (principally the architect and general contractor). The contracts must spell out in a consistent and complete manner the respective roles and responsibilities of every person who participates in some manner in the design and construction of the project. The documents should also make it clear that it is the developer, not the architect or the contractor, who ultimately controls this project stage. Finally, it is the real estate

development lawyer's job to add sufficient teeth to the documents so as to incentivize the design and construction professionals to complete construction of the project on time, on budget, and in full accordance with the project design selected by the developer.

STAGE 7: NEGOTIATING THE PROJECT LEASE

Developer's business objectives

The prior six project stages are all centered on the cost side of the developer's business. Stage 7 is where the developer makes its money. The profitability of a project is directly tied to the developer's success in meeting the following three leasing objectives:

1. The project should be leased at rents that are consistent with or better than the project's initial financial projections;
2. The lease-up of the project should occur within the time frames set forth in the project's business plan; and
3. The project should be leased on business and legal terms that are consistent with the expectations of the developer's "second customer"—that is, the institutional investor, who will ultimately invest either debt or equity in the project.

The developer's profit on the project will suffer if it fails to meet any of these objectives.

Lawyer's job

The first thing that the real estate development lawyer needs to understand at this project stage is that he or she is part of the developer's marketing team. In Stages 1 through 6, the developer is the consumer (buying land, seeking governmental approvals, securing construction financing, etc.). At the leasing stage, the developer is selling its product to its customer. The last thing a developer needs at this crucial, money-making stage of the project is a lawyer who revels in playing the role of the hard-nose by preparing the most egregious, one-sided lease imaginable and then being intractable in his

or her resolve to win the negotiation of every point in the lease document. Tenants always have choices, and one choice they often make is not to deal with a developer that is represented by a lawyer who chooses to kill rather than make deals.

Conversely, a lawyer can add real value to the client's project if he or she:

- Prepares a relatively short lease document that covers the essential deal points and protects the developer's legitimate business interests, but is still readable and relatively user-friendly;
- Focuses the lease negotiations on those provisions that make or save the developer real money (for example, the rent, operating expense, and tenant improvement provisions) and limit the amount of time spent on the negotiation of relatively insignificant legal issues (for example, the attempt to craft a pluperfect subordination or eminent domain clause);
- Makes sure that the terms of the lease conform to the expectations and requirements of the institutional investor community; and
- Includes provisions that make the lease easy (and therefore, cost effective) for the developer's property manager to administer.

Real estate development lawyers who follow these four simple rules will make their clients money in both the short and long terms.

STAGE 8: EXECUTING AN INTERIM EXIT STRATEGY

Developer's business objectives

Once the project is fully leased and cash is flowing, the developer faces the question of what to do next—should it sell the project outright or should it retain full or partial ownership of the project for some extended period of time?

Sale of Project

The advantages of a quick project sale are that: (i) it puts cash into the pockets of the developer in an amount equal to the sum of its capital contributions

to the venture, plus the incremental value of the project over its development costs; and (ii) it eliminates any risk that a future occurrence (for example, a tenant bankruptcy or a downturn in the economy) will erode the profit inherent in the project. An outright sale of the project will, however, be a taxable event and will subject the developer to income tax on the excess of the project's sales price over the project's adjusted tax basis (which, at this early stage in the project's history, is generally equal to the project's development costs).

Retention of ownership

Many developers prefer to hold on to their developed projects for an extended period of time, so as to take advantage of both: (i) the continuing positive cash flow produced from the project; and (ii) the anticipated increase in the value of the project over time. By doing so, the developer postpones the imposition of any tax on the project's profit until the date of its ultimate sale. The retention of an ownership interest in the project does, however, subject the developer to the ongoing risk that some event will occur in the future that will decrease (or wholly eliminate) both the project's positive cash flow and its incremental value. Some developers try to limit this risk by retaining only partial ownership of the project.

If the developer opts to retain an ownership position in the project, it will nonetheless want to pay off its construction loan as soon as possible after the project is fully leased. The typical construction loan has three features that do not comport with the developer's continuing ownership of a fully leased project:

1. The developer (or one of its affiliates) is personally liable for the repayment of the construction loan;
2. The interest rate of a construction loan is a variable rate that is subject to increase if the financial index to which it is tied increases (e.g., the prime rate or the London Interbank Offered Rate); and

3. The construction loan provides for the full repayment of the loan within a relatively short period of time after the completion of the project (usually no more than one or two years).

A developer who wants to retain ownership of a project (in full or in part) can do so and still pay off the construction loan by:

1. Replacing the construction loan with a permanent, non-recourse loan;
2. Contributing the project to a newly-formed joint venture with an institutional investor, with the investor making a cash contribution to the venture sufficient to retire any construction debt; or
3. A combination of 1 and 2.

Under each of these alternatives, the developer will have positioned itself to continue to enjoy the economic benefits from the project (positive cash flow in the short-term and continuing appreciation in the value of the project in the long-term). A developer who wishes to cash out a significant part of its equity in the project (represented by both its initial cash contribution to the project and its interest in the incremental value of the project over its development costs) will likely choose either alternative 2 or 3. If the developer has no particular desire or need to realize on its equity in the project, then it is more apt to simply refinance the project with a nonrecourse, permanent loan and retain ownership of 100 percent of the project.

Lawyer's job

At this stage, the real estate development lawyer's first mission is to advise the developer client about which of the available interim exit strategies will best achieve the developer's business objectives. In order to render effective advice on this topic, the development lawyer must be well-versed not only on the economics of the subject project, but also on the economics of the developer's business as a whole. The development lawyer must also determine if there are any outside equity investors whose approval is required as a condition precedent to the implementation of an interim exit strategy

(and, if there are, what options are available to the developer if they fail to approve the developer's selected strategy). Finally, the development lawyer must once again put on the tax lawyer hat to make sure that the selected exit strategy does not result in any unexpected tax consequences to the developer or any of its equity investors. Once the decision is made as to which interim exit strategy will be implemented, the real fun starts for the real estate development lawyer. Regardless which interim exit strategy is selected, the legal documents required to evidence the transaction will be complex and voluminous—two words that are music to the lawyer's ears.

STAGE 9: OPERATING THE PROJECT

Developer's business objectives

The developer's economic desires for the project during this operational stage are relatively simple and straightforward: (i) to maximize and stabilize the project's annual cash flow; and (ii) to enhance the long-term residual value of the project. In order to achieve these goals, the developer wants its project operations to proceed in accordance with the following guiding principles:

- Keep the project full with tenants paying rent at or above the pro forma rents;
- Hold project expenses at or below the pro forma expenses;
- Maintain the project in a good condition and order of repair; and
- Keep both its tenants and its equity investors happy.

The job of keeping the project full usually falls to a licensed real estate broker, while the remaining three tasks are assigned to a property manager. Whether the developer staffs these roles internally or externally is largely a matter of the developer's personal preference and business style.

Lawyer's job

If the developer opts to staff project operations externally (that is, by outsourcing these functions to independent third parties), the development lawyer will need to put together the agreements retaining the broker and property manager. Those agreements should clearly delineate what is expected from the broker and the property manager and should be for relatively short terms, so that the developer can go a different direction if the third party's performance is not acceptable. During the operations stage, the development lawyer also assumes the role of a legal handyman, taking on whatever legal matters might arise with respect to the day-to-day management of the project. By way of example, the development lawyer might have to deal with a tenant bankruptcy one day and an on-site environmental spill the next day.

STAGE 10: SELLING THE PROJECT

Developer's business objective

Forget about the maxim that real estate is all about "location, location, location." The reality is that timing is an equally important contributor to the ultimate success of a real estate project. The developer's business objective at this final project stage is quite simple—to try to maximize its profit by picking the optimal time to sell the project. Selecting that optimal time is, however, much more of an art than it is a science. Real estate is an inherently cyclical business, with the up and down cycles lasting for not just months, but years. The developer who waits too long to pull the trigger on its project sale may end up seeing all of the value of its project permanently eroded during a lengthy downturn in the real estate markets—something that happened in the aftermath of the 2008 recession and is now happening in the COVID-19 era. The moral of this story is that the successful developer should seek to err on the side of selling its project too early rather than too late.

Lawyer's job

In the first instance, it is the real estate development lawyer's job to create the legal flexibility to permit the developer client to sell its project when the

developer decides that the time is right to do so. Developers do not take kindly to hearing from their lawyers that the provision of some lease, financing agreement, or other legal document makes the sale of a project at the time selected by the developer economically infeasible. The real estate development lawyer's mission is to anticipate the developer's ultimate sale of the project by creating contractual exits for the developer at each of the prior nine project stages.

The project sale also presents the real estate development lawyer with a unique and interesting opportunity to have a significant body of his or her legal work scrutinized and critiqued by an army of lawyers, accountants, and other real estate professionals retained by the buyer to perform due diligence on the project. To the extent the job was done properly in the prior nine project stages, this process will be relatively painless for the development lawyer (and maybe even a bit rewarding). To the extent he or she failed to do the job in those earlier stages, the development lawyer will get to witness first-hand the economic fallout that poor lawyering can have on a real estate project. 🍀

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