STRADLEY RONON

RE Developments

A Publication of the Stradley Ronon
Real Estate Practice Group

WWW.STRADLEY.COM

APRIL 2018

Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
New Jersey
Illinois
Delaware

Exploring Joint Ventures in Real Estate Transactions

by Christopher W. Rosenbleeth

This article is the first in a series exploring joint ventures in real estate transactions. A joint venture, generally speaking, is any combination of two or more parties for the purpose of pursuing a common investment or investments. In real estate, any particular such combination often involves, on the one hand, a developer or operator and, on the other hand, one or more sources of equity.

For purposes of our discussion, we are making two assumptions. First, the project for which the venture is created is a single development project (as opposed to a stabilized property or multiple projects). Second, we assume that the joint venture will include only two parties – a developer and an investor equity partner.

Finally, while tax considerations are beyond the scope of this series, note that the economics of a joint venture can be, and often are, informed by tax considerations. Any party entering a joint venture should consult its tax advisers to ensure that it will obtain the intended tax treatment.

(continued on page 2)

What You Need to Know About How Blockchain Technology Could Transform Property Transactions

by Caroline C. Gorman

Over the past few months, you likely have found yourself sitting around a table discussing Bitcoin, Ethereum or some other form of cryptocurrency. We all know someone who has invested in it and won big, lost big or has a tip to share about the next big thing in cryptocurrency. But the conversation inevitably shifts to what people know about how cryptocurrency works. And "how it works," through blockchain technology, could transform how property transactions are conducted.

From a high-level perspective, blockchain is a decentralized electronic ledger that memorializes transactions in blocks of computer code. Each block of code includes, among other things, information related to the previous transaction in the chain, code for the current transaction in the chain and a time stamp to memorialize when the transaction took place. One of the main benefits of blockchain is that once the transaction is completed and the blockchain is created, it is extremely difficult, if not impossible, to alter the blockchain retroactively. Because the blockchain is so difficult to modify, the parties to a transaction creating the blockchain have confidence that the record and terms of their transaction are safe. Further, subject to certain permissions to access the blockchain platform, the blockchain is accessible to all parties to a transaction in real time, so they never have to worry that the finality or terms of their transaction could be questioned or altered by a third party.

The nature of blockchain technology in creating an immutable record of any transaction is exactly why blockchain may become prevalent in real property transactions.
There are countless opportunities to utilize blockchain technology that could benefit buyers,

(continued on page 4)

Exploring Joint Venutres *(continued from page 1)*

Formation and Organization of the JV

While various choices are available for the form of a joint venture, a discussion of the variables that inform a choice of entity determination is beyond the scope of this article. A limited liability company (LLC) is the most prevalent form of entity chosen. LLC statutes provide the most flexibility among the different types of entity in terms of governance and equity structure. Participants in the joint venture – who become the "members" of the LLC – essentially can agree on whatever terms they see fit. In addition, each member in an LLC has limited liability. As opposed to a limited partnership, however, in which a general partner is liable for the debts of the limited partnership, the liability of every member in the LLC is limited to the amount of such member's contributed capital.

Once the parties settle on the form of entity, they must negotiate and enter into a joint venture agreement. For an LLC, this would take the form of a limited liability company agreement (or "operating agreement"). In this article, we will refer to the agreement executed among the parties as the "JV Agreement." The JV Agreement is the main document by which the parties memorialize their relationship.

Economic Features of the JV

Fundamentally, parties enter into a joint venture when there is a shared belief that, as between such parties, the whole is greater than the sum of the parts. The parties presumably believe that the potential returns are greater in the relationship than if each party proceeded alone. The parties' interests at the outset of the relationship generally are aligned, but relative to the economics, will be competing. How or what a party contributes to the joint venture and how and when the parties receive their return, probably are **the** core issues for the two joint venture participants.

Contributions – Placing One's Bets

At the outset of the joint venture, the parties will determine who is contributing what to the LLC. The developer wants to receive proper credit for what it has done prior to the venture. The investor wants to ensure that its capital is being deployed as intended, and that the project costs will be in line with the investor's underwriting. Contributions can take several forms such as cash, real property or other assets.

Each party will have an initial required contribution. For the developer, this can include the real property for the project, if it is already owned,[1] as well as any "pre-development" costs (such as the cost of obtaining entitlements or financing costs), and any costs and expenses such as legal fees that the developer has paid already but which benefit the joint venture. The investor's initial capital contribution may include some amount to reimburse the developer for the investor's pro rata share (based on the parties' respective interests in the newly formed entity) of the pre-development costs, all or a portion of the purchase price of the real estate (whether or not already owned by the developer) and other closing costs.

The JV Agreement also should address when additional capital contributions will be required from either party. In our case, the developer typically will not have ongoing contribution obligations, except in specific circumstances (like cost overruns). The investor, on the other hand, likely will not fund all of its required capital contribution at closing. Most of the time, the JV Agreement will include a business plan approved by the members that, among other things, outlines the timing of the investor's additional capital contributions. The investor will be required to make any additional contribution to the extent consistent with the business plan. Much like a construction loan from a senior lender, the investor's additional capital would be contributed against presentation of invoices for materials or completed work, a calculation of remaining capital due, and/or an inspection of the work completed. The business plan should include other nondiscretionary items, such as taxes and insurance premiums, that must be paid during the course of construction even if the property is not yet stabilized.

What if additional capital is required for items **not** in the business plan? The investor's liability for mandatory capital contributions is capped, and additional capital contributions will require investor consent. If cost overruns arise, the developer may be obligated to cover those out of its own pocket, or to pay a disproportionate amount of the same.[2] The parties might negotiate specific circumstances where both parties cover their proportionate share of cost overruns, if the same occur through no fault of the parties, like a sharp increase in commodities pricing or property taxes. However, in most cases the investor will have significant negotiating leverage, and will require the developer to pay for the overruns (and may even require a guarantee of payment by a principal).

The JV Agreement should address a party's failure to fund additional capital in accordance with its terms. First, the JV Agreement might permit the non-defaulting member to make a loan to the defaulting member and, if that loan remains unpaid at some later date, to convert that to an additional capital contribution. Conversely, the JV Agreement may provide that the non-defaulting member can make a loan to the LLC itself. In either case, such a loan typically would accrue interest at a very high rate (say, 20 percent) and receive a senior position in the distribution waterfall. A non-defaulting member may contribute additional capital to the LLC; in this case, the members' pro rata interests in the LLC can be adjusted on an overall basis, or there might be so-called penalty dilution, in which case, the defaulting member's percentage interest would be reduced on an accelerated basis relative to the parties' overall contribution. Finally, a defaulting member may lose its voting rights in the LLC.

Distributions – Cashing In

While the provisions around capital contributions are extremely important, the parties' real interest likely lies in the distribution provisions, which set forth the terms upon which the parties will receive returns on their investments. The mechanics of how the parties receive their distributions are commonly referred to as the "waterfall," and the waterfall can be very simple or exceedingly complex. In its simplest form, the waterfall will be "pari passu," meaning each party's return ranks equally, and "pro rata," meaning each dollar distributed will be split relative to the parties' split of the membership interests in the LLC. However, in most joint ventures, the waterfall will include some or all of a preferred return, an internal rate of return (IRR) hurdle and/or a promote. The economic structure of the waterfall is subject to the parties' negotiations, and the following examples are meant to be illustrative, but are not exhaustive.

First, note that JV Agreements typically differentiate between returns of net operating income and distributions of proceeds from a capital event, such as a sale or refinancing of the project. Net operating income, or NOI, is the amount of cash flow the project generates after paying property-level, and often entity-level, expenses, such as taxes, insurance, general operating expenses and debt service. A new development probably will not generate substantial NOI for quite some time. The JV Agreement may specify when NOI is returned – typically on a monthly or quarterly basis or as otherwise decided by management.

What the parties **really** care about, though, is the distribution upon a sale or refinancing of the project, as this is where the money is made. The investor partner may want to receive its invested capital, often with interest, before the developer receives anything. The interest component is commonly referred to as a preferred return. The preferred return will be priced to pay the investor for putting its capital at risk and current "market" terms generally range from 8 to 13 percent. In many cases, the waterfall would distribute net proceeds of a capital event, first, to the investor until the investor has received all of its contributed capital plus its preferred return. In some cases, the developer also receives a preferred return on its contributed capital, in which case the investor and developer would receive pro rata distributions until both parties have received their respective preferred returns.

The waterfall may include a threshold that members must receive on contributed capital before returning other amounts. This is commonly referred to as the "hurdle," and most often the hurdle is based on the IRR on the contributed capital. The JV Agreement will specify how the IRR is to be calculated, for example, using the XIRR function on Microsoft Excel. In a waterfall with an IRR hurdle, the investor and developer will receive pro rata distributions until the investor has (or, sometimes, both members have) received distributions sufficient to generate an IRR of some stated percentage. A typical IRR hurdle is 15 percent but may be higher or lower depending on market conditions.

Once the IRR hurdle is met, the distributions typically toggle so that the developer begins receiving distributions that exceed its membership percentage. This is commonly referred to as the "promote" or "profits interest." The developer receives a promote to recognize that the developer's expertise and ability add value to a project. The promote also incentivizes the developer; once the promote is being paid, the developer will receive a percentage of the profits that exceeds its relative capital contribution. As an example of a promote provision, the JV Agreement might say that net cash proceeds from a capital event will be distributed to the members, in proportion to their respective interests, until the investor has (or both members have) received a targeted IRR; thereafter, the remaining proceeds will be distributed 40 percent to the developer and 60 percent to the investor (the particular split will be subject to the parties' negotiation). A developer typically would forfeit its promote upon its default under the JV Agreement or removal as the manager of the project.

For questions related to the foregoing, please contact Christopher W. Rosenbleeth at 215.564.8051 or crosenbleeth@stradley.com.

In addition to the foregoing, the waterfall may include other provisions. These provisions can be subject to negotiation but often bear correlation to other settled economic terms. For example, if the JV Agreement permits a non-defaulting member to make member loans or shortfall loans upon a party's failure to fund additional capital contributions, those might be repaid first in the waterfall. In a promote structure, any promote paid to the developer may be subject to a clawback in the event that the investor's actual IRR is less than the targeted amount stated in the JV Agreement (as a result of the timing of prior distributions).

Other Economic Terms

While distributions are the means by which the parties receive return on their capital investment, they are not the only way by which the parties can make money. In particular, the developer often receives a contractual payment for developing the project, or a developer's fee. The developer might also receive a construction management fee, in exchange for managing the project; a financing fee in exchange for finding debt financing for the project; and/or a fee for providing any guarantees to debt providers for the project. All of these are negotiable by the parties at the outset and, while pertinent to the JV Agreement, often are documented separately – for example, in a development agreement between the joint venture and an affiliate of the developer member. Like the promote, the investor may require also that fees paid to a developer are subject to clawback in the event the investor does not receive its contracted-for return.

In Closing…

There are myriad ways in which the parties to a joint venture can address the economics of the parties' relationship. How the parties "split the pie" entering into, during and at the end of the relationship can take many forms. In our next installment, we will address the management of the joint venture. ▪

---

[1] In many cases, the developer will have the real property under agreement for acquisition, and the joint venture will close on the purchase.

[2] The risk of cost overruns in a project may be reduced if the general construction contract is a "guaranteed maximum price" contract.

Blockchain Technology *(continued from page 1)*

sellers, brokers, title agents and lenders. In real property transactions, one of the first steps a party takes when seeking to buy, or lend against, a property is to enlist a title company to run a property search. The title company ensures that the factual record (e.g., current owner, liens of record, title defects) is accurate. The process can be lengthy and expensive and is subject to human error. Further, even when one is utilizing a trusted title company, a property search may result in inaccurate or incomplete information. The use of blockchain technology for property transactions could address these issues.

If property records and property transactions were documented using blockchain there would be far fewer, if any, surprises in future transactions. The efficiency with which property records could be authenticated in a blockchain system may mean less cost and risk to those involved. Though not yet in use for the majority of jurisdictions, a few jurisdictions, including Cook County, Illinois and South Burlington, Vermont, have begun programs to utilize blockchain systems for property transactions. The way the jurisdictions participating in blockchain system programs and the way industry leaders envision property transactions being documented on a blockchain platform going forward is that each property or parcel has a specific digital identifier that is part of each transaction documented with respect to that property. Each time a transaction occurs, the digital identifier is embedded in the blockchain and a record of the transaction is made.

Currently, the way property transactions occur and records are kept is that when a property is sold, the buyer receives an original executed deed as evidence of the transaction. The buyer then records the deed with a local government office. Thus, the conveyance of the property pursuant to the deed and the recording of the deed on the public record are not simultaneous. This delay between conveyance and recording creates the opportunity for fraud in the interim (for example, a seller who "sells" his property twice to unsuspecting buyers). When transactions are executed on a blockchain, the conveyance and the public record are made simultaneously, thereby eliminating the opportunity for fraud.

Blockchain technology also transforms property transactions by eliminating the inconsistency of record keeping across states and counties. In each property transaction, parties deal with local offices that maintain the public record for real property transactions. Each of these offices has its own standards and requirements for recording documents. For example, some jurisdictions might require a certain font size, a particular header or margin, or specific recording fees related to the number of pages in the document. Even assuming those local requirements are met, documents evidencing land transactions can be misplaced or improperly recorded, which causes a defect in the chain of title. Further, though many jurisdictions have moved to electronic record keeping, some still maintain paper records, which further complicates the process of recording a conveyance and later confirming the chain of title by searching the property records. Beyond the inconsistency of the process, each of these steps is also susceptible to human error. Blockchain eliminates the inconsistency of record keeping, enforcement of recording requirements and the multistep process that introduces opportunity for human error. Once a transaction is completed using a blockchain system, the record of the transaction is made without the need for further action by the transacting parties or public officials.

Being able to verify a chain of transactions is one of the most important aspects of property law. Though many jurisdictions have attempted to "clean up" property records and make the process more consistent, the fact that property transactions are not easily verifiable means that the system is fundamentally flawed. Blockchain technology could eliminate poor record keeping, a lack of easily accessible verifiable information and fraud concerns – issues practitioners have dealt with in property law since the beginning of time.

Only time will tell if blockchain technology is the catalyst for change in property law (and beyond) that those familiar with the technology believe it to be. But the opportunities for change and innovation of property transactions through blockchain technology are on the horizon, and figuring out how blockchain technology can benefit you and your business is the first step. ■

For more information on blockchain technology and its effect on and use in property law, please contact Caroline C. Gorman at 215.564.8633 or cgorman@stradley.com.

Proposed 1 Percent 'Construction Impact Tax' to be Assessed on New Philadelphia Construction

by Tyler W. Mullen

Beginning July 1, new development in Philadelphia may be subject to the so-called Construction Impact Tax (the Tax), as outlined in Bill No. 180351 (https://phila.legistar.com/LegislationDetail.aspx?ID=3476383&GUID=BECDA59D-7A22-45F8-8E64-3E462BCD9D0C&Options=ID%7cText%7c&Search=180351) (the Bill). The Bill was formally introduced at the Philadelphia City Council meeting held on April 12, but has yet to be voted on.

If the Bill is ultimately enacted, a large portion of new construction in Philadelphia will be impacted. New construction subject to the Tax would entail ground-up development, as well as improvements to existing structures, including any "repairs, constructions, or reconstruction, including additions and alterations." Only structures meant for "human occupancy" will be taxed, including residential, commercial and industrial structures, so some structures (e.g., signs, fences) will escape the Tax.

The amount of the Tax is equal to 1 percent of actual construction or improvement costs, payable by the property owner upon issuance of a building permit. No building permit will be issued until the Tax is paid. If the taxpayer does not know the actual construction costs when applying for the building permit, then a certified best estimate must be submitted. If construction costs deviate from the estimate provided, the taxpayer will pay additional taxes at a later date or receive a refund.

The proceeds generated from the Tax will be deposited into the Philadelphia Housing Trust Fund (the Fund) and used to assist low-income Philadelphians in purchasing affordable housing and constructing new affordable housing units.

For more information on the Construction Impact Tax, please contact *Tyler W. Mullen at 215.564.8589 or tmullen@stradley.com.*

How the Bill will compliment, or perhaps replace, another affordable housing bill pending before City Council is yet to be seen. Bill No. 170678 (https://phila.legistar.com/LegislationDetail.aspx?ID=3088278&GUID=1CD43D48-21EC-413B-9886-37159739FE87&Options=ID|Text|&Search=170678) is currently causing a great deal of controversy because, if enacted, it would require developers of residential projects containing more than 10 units to either pay into the Fund or designate 10 percent of their units as affordable units. Whether the Tax will replace the framework proposed under Bill No. 170678, or be an addition to that framework, will hopefully become clearer in the coming weeks. In the meantime, lively debate on the merits of the Tax, and its effect on future development throughout Philadelphia, will surely abound.

Please see our prior coverage of Bill No. 170678 here (https://www.stradley.com/insights/publications/2018/01/real-estate-alert-january-2018). ▪