

**PORTS PARTNERING
WITH PRIVATE DEVELOPERS:
A PUBLIC APPROACH TO REAL ESTATE DEALS**

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1. Public Private Partnerships (“PPP,” “3P” or “Triple P”)

Many ports want to redevelop their landholdings but do not have the vast amounts of money needed to undertake redevelopment of very challenging areas. Often, these properties are brownfields and have been historically industrial, so bringing residential, office and retail life to these areas is a risky proposition. Although the views may be great, the infrastructure is not. Buildings literally may be sinking on rotting piers into polluted tidelands. Ports therefore need to stimulate private investment to stretch the redevelopment dollar. Thus, “Public Private Partnerships” are quite in vogue.

PPP is used loosely to mean all kinds of development where public and private intersect. This paper examines deals of the type more akin to legal partnerships, with public and private investment in a joint enterprise with expectations of returns on both sides. The role of the port typically is to develop the major infrastructure components and public amenities; the developer’s role is to build the income-producing portions (e.g., office, commercial, residential). Developers approach these deals as they do any other, with the usual expectations, the unavailability of which they may not appreciate when partnering with a public entity. Ports need to be alert to the issues and limits on their authority so they do not concede to developers’ structuring proposals (that may sound perfectly reasonable in a private context) and find themselves in the midst of something they ought not to be. Port staff and advisors need to approach these projects like the real estate developments they are and determine how, given the constraints on their authority, they can achieve their redevelopment goals without running afoul of state law.

2. Public Entities—The Constraints

2.1 Getting Paid. To start with the basics, ports are public entities and, as such, usually cannot be partners (in the legal sense) with private entities. Many states’ laws prevent states, cities and other public entities from being partners, members or shareholders of private entities (other than through authorized financial-type investments). (Some states authorize specialized public development corporations to enter into private partnerships; those are not addressed here.) For ports, this means no sharing of profit and risk with the development partner. But redevelopment does not come cheap, so how does a port obtain a return on its investment and pay its financing costs?

There are three basic ways to get money out of a real estate deal: (i) as a partner with an equity interest (usually not legally permitted); (ii) as a lender (may be permitted depending on the state); and (iii) by receiving fees for services, proceeds from property sales and rental income (permitted). In analyzing a real estate redevelopment, the parties need to be very precise about these possible relationships and roles. Each piece of the return to the port needs to be reviewed and put into a particular category; mushing them together can disguise problems with the deal. For example, if the developer proposes payments more in the nature of an equity return (e.g., dependent on the success of the venture), the parties may need to see if this can be restructured as a return on debt (including consideration of whether a contingent interest feature would be permitted under state law). This is because if the payments to the port are seen as being in the nature of an equity interest, the port may be deemed to be a partner of the developer, with the attendant liability.

If a port is going to act as lender, what will be the debt secured? Likely it will be the purchase price for the sale of property to the developer. What will be the security for the loan--can the port take a mortgage to secure the debt? Perhaps yes. In contrast, mezzanine financing¹ is a key element of most developer's financing. It may be inappropriate, however, for a port to be a mezzanine lender because a port may not be able to foreclose on the pledged equity interests, as this would make it an owner of a beneficial interest in the developer at some level. In addition to exceeding the port's statutory authority, this is also a bad idea from a liability standpoint (e.g., the port does not want to be an owner of the entity that is developing condominiums when the first homeowner claims for leaking building envelope systems are filed).

If the port is going to receive fees for its services, does it have the statutory authority to collect these fees? Are these fees disguised taxes or impact fees that must be charged equally to those similarly situated? Some states have statutes governing development agreements and impact fees; these may be designed to ensure that the cost of infrastructure that benefits the public as a whole is not unfairly charged to a particular developer. What is the timing of payments and what are the remedies for failure to pay the fees? Should the port take a mortgage (junior to the project lender) to secure payment of fees?

In other words, each category of proposed payment to the port should be separately specified and analyzed, from the creation of the obligation to the question of "what if?" the developer defaults.

2.2 Lending of credit. Many states have constitutional or statutory limits on the authority of public entities to make loans, lend credit or make gifts of public funds to private persons (perhaps with exceptions for the needy, ill, elderly and the like). The principle is that taxpayer money should be used for the good of the public as a whole, not for the benefit of

¹ Mezzanine financing involves a constituent entity of the developer's property-owning entity borrowing money and pledging its membership or partnership interest in the property-owning entity to the lender. Mezzanine financing can occur at any level of ownership—i.e., the borrower may be a member of a member of the property-owning entity. This type of financing is riskier and thus carries a higher rate of return. The remedies for default are to take control of the entity and effectively take control of the project. Sometimes mezzanine lenders also insist on taking a junior mortgage on the real estate to provide an alternative remedy.

particular private persons. One outcome of this may be the need to receive fair market value for the sale or lease of property, as determined by independent appraisal. If a port disposes of real property for less than fair market value, the difference may be an impermissible gift to the developer. There is often some flexibility in how value is determined (e.g., value may be assigned to other items that the developer is contributing or paying for, such as some environmental cleanup or infrastructure installation) and questions arise over how old the appraisal can be and the parameters given to the appraiser (e.g., will there be restrictive covenants imposed on the land that affect value?).

This principle also may require values to be refreshed periodically over phased developments with multiple closings. The problem with this is that many redevelopments are challenging to assemble, involve lots of public process and require creative financing. Thus, they often occur over a period of many years, raising the issue of whether values (and thus property prices) should be updated over time.

2.3. Property and Excise Taxes. Tax planning is an important feature of any real estate development. Working with a public entity introduces property tax considerations to the mix. Port property in most states is exempt from local property taxes. Transferring the property to a private entity will cause that exemption to be lost. Leasing property, rather than selling it, may involve alternative methods of taxation (e.g., in lieu of taxes or taxes on the rents) that should be considered. In addition, particular property tax abatements may be available for certain types of uses (e.g., affordable housing or job growth incentives).

2.4 Public Works. Public works requirements dictate how construction is conducted on public land or with public funds. The rules differ among the states, but the basic concepts involve public bidding, prevailing wage and WMBE. Organized labor concerns may also come into play. With each of the private and public entities constructing its own parts of the project, it is important determine out which pieces must be done in accordance with the public works rules. These might be applicable to work done on public property—but perhaps not if no public funds are used in the process. If facilities have both uses in them (e.g., a condominium building with port offices on the first floor and commercial offices above), is public bidding required? The answer might depend on which entity is hiring the contractor and is at risk for cost overruns, as well as the proportion that the public piece represents of the whole (one floor out of three or one out of ten?). Even if the building is built by the developer outside of the public works rules, perhaps the tenant improvements for the port can be publicly bid.

Clearly, infrastructure on public property not being sold or leased (roads, utilities, environmental cleanup) with public funds will be done as a public work. What about facilities that are built by the developer and gifted to the port as part of the deal (e.g., a marina office, public restroom facility, an esplanade)? Often, these are cheaper to build as part of the developer's construction contract and may even be integrated into the developer's building, so it may make sense to have the developer build them. The applicability of public works rules in each situation will need to be analyzed, a task made more difficult because many public works laws were written in simpler days.

2.5 Staffing. Given the sophistication of these redevelopment projects and the length of time it takes to complete them, ports must plan to have sufficient staff with the right expertise to monitor them for years. Institutional knowledge is important to remembering the how the pieces fit together and the port may need to create special positions. Highly capable financial analysts are a must to help the port run the numbers and figure out the deal. Clearly, development experience is very helpful, but caution must be exercised in hiring straight from the private sector. This is because appreciation of the constraints under which ports, as public entities, must operate is critical. Some of the rules are not obvious and it takes considerable experience to be able to spot the issues hidden in complicated structures. So staffing costs should be taken into account when analyzing the costs.

2.6 Land Banking. As discussed above under lending of credit, it may be a violation of state law to make a gift of public property (e.g., by selling it too cheaply). A companion to this is a basic fairness issue. The developer desires to tie up the property for long time at a favorable price while it spends a lot of money on planning, permitting and financing. Millions of dollars will undoubtedly be spent before a shovel is put in the ground. In a commercial deal, would be unusual for a buyer to be able to hold onto a purchase price for longer than 6-18 months without additional payments, depending on the market and the expected permitting time for the project. Given the lead time on these projects, though, it may indeed be reasonable to hold a price for longer than a seller would in a well-developed area. If the development is successful, however, prices in the redevelopment area will rise, in part due to the port's substantial investment in infrastructure and public amenities. The port has an interest in seeing that the developer does not "land bank"—hold on to parcels (or the right to buy parcels) it is not yet ready to develop for an unreasonably long time at yesteryear's prices. Not only does this help insure an appropriate return for the port, the port may also have an interest in getting a variety of developers involved and giving others the chance to bring their vision to the redevelopment.

2.7 Condemnation. Rules governing condemnation for private use vary by state. Some states permit takings of blighted areas for redevelopment by private developers. E.g., *Kelo v. City of New London*, 545 U.S. 469 (2005). Others states are more restrictive and do not allow any takings for private use. Developers may be need to be educated on this point to understand that the port may not be able to just condemn private property (such as a long time shipbuilding operation that has been on part of the property for many years) and hand it over to be redeveloped as an office building, even if this would clean up the neighborhood and stimulate economic growth.

2.8 Public Financing. The "public" in "public private partnerships" means that the port is going to be contributing financially in one or more ways. Contamination must be remediated, piers replaced, roads and sewers installed and public access features constructed. These are the very sorts of things that do not generate revenues, making public financing a challenge. These are also the items that the developer cannot afford to build (unless the property prices are reduced to account for the cost). If the port does not want to use its general tax revenues or general obligation bonds, it will need to consider the revenue source to pay for its components. This could be a combination of property sales, lease revenue and fee revenue. The problem with these sources is that they are dependent on the developer performing in a timely

manner. If the developer gets in trouble or the market changes (or does not respond as favorably as assumptions indicated), what will be the source to pay the port's financing costs? These should be analyzed under worst case scenarios (e.g., that the developer goes bust, development stops and a lender takes over), as it goes without saying that the development business is very tricky and a project's prospects can sour quickly for unforeseen reasons.

Another aspect of the public's financing obligations is often overlooked. It is important to consider the long term financial health of the public infrastructure over its useful life. It is not enough to find the money to build a public dock and beautiful esplanade with public restrooms, art and meeting places in and amongst the new commercial development. It must be maintained over many decades. Ports need to consider the funding mechanism to maintain the infrastructure over the long term. This takes advance planning, such as creating an owners' association (before any property is sold) to levy assessments to replace piers, pick up trash, plant flowers, repair sidewalks and paint benches.

2.9 State Audit. The port should assume that, at some point, the state auditor will scrutinize the project. Port staff should be preparing the files all along to help the auditor track the deal—the investments and the returns—so the auditor can see that state law was followed in all respects. This may be challenging with aspects of the project that push the envelope and do not fall squarely within state law. The auditor may need assistance in seeing the framework under which the port analyzed and approved the project. Staff should assume that, especially if the project goes badly or there are complaints, the scrutiny will be intense. Keeping this in mind should help to stay on the right side of state law issues in putting the deal together.

2.10 Open Public Meetings and Freedom of Information Act Requests (FOIA). Ports generally operate under open public meetings laws. Port business must be conducted in the public eye and in regularly scheduled, well advertised public meetings. Smaller port commissions² may meet only monthly. Commissioners will need to be briefed and plans displayed in all their glory—all under the watchful eye of neighbors, interest groups and newspaper reporters. Developers may not appreciate what this entails, including explaining financial details in a public forum and being prepared for hard questions from both commissioners and the audience.

Given the need for commissioners to act in public, advertised meetings, getting documents signed pursuant to consent resolutions in lieu of meetings and hastily called meetings to address changes under looming deadlines may not be possible. Developers need to be mindful of this when, for example, their lender imposes a last minute requirement needing port consent on the eve of closing.

Developers also need to appreciate that port documents are subject to Freedom of Information Act requests (with limited exceptions). All of the documents submitted to the port, including financial statements, will be available to interested persons (such as reporters) who take the time to make a FOIA request. These documents may well be quoted in unflattering newspaper articles. Some of the information may be especially sensitive. Particularly with

² "Commission" in this paper is used to mean the governing body of the port. Its members, the commissioners, are usually elected or appointed public officials.

regard to financial statements, it may be appropriate to have port staff inspect the information at the developer's offices and have a contractual right to continue to do so, rather than having this information lodged in the port's files.

2.11 RFPs. Developers for PPP projects are often selected through a competitive process. Crafting a good RFP is worth the time and expense up front. It should describe in detail the requirements for the development and investment. Critical elements of the response will include the proposed uses, conceptual design, partners, financing plan (including equity investors), timeline and price, as well as how the project will integrate with the public elements. The experience of the developer and its partners in similar types of redevelopments as an important selection factor cannot be underestimated. The RFP also should explain how the decision will be made (e.g., points system), as this analysis of proposals will be done in a public meeting. The RFP should also provide the flexibility to address the inevitable changes along the way as the planning for the project moves through the process.

2.12 Sale vs. Lease. Port policy makers need to have discussions at the outset about their philosophy on selling versus long term leasing. They may be constrained by state law or charter from selling waterfront property, beaches or tidelands. State law may also impose limits on lease terms and require periodic rent adjustments. Development can occur on ground leaseholds, but it is more difficult and requires long term leases (e.g., 50-99 years). Refinancing becomes problematic toward the end of the term because lenders require 20-40 years of lease term past their loan maturity. This means that, although ground lease financing may be available in the early years of the lease term, it becomes more challenging in year 30 of the term. Lenders will also have to be given ample opportunity to cure defaults and step into the shoes of defaulting developers.

2.13 Environmental Issues. Port property slated for redevelopment is often contaminated from years of heavy industrial uses. Key to structuring a PPP project is allocating responsibility for environmental issues. If port-related activities caused the contamination, the private parties will expect the port to be responsible. This responsibility may involve not just cleaning up the property but extend as well to indemnities granted to the developer and its lender. The issue is inevitably more complicated with other responsible property owners, tenants and public entities, each of whom contributed over time to a polluted waterway and uplands. The developer may not really care about the nuances of who spilled what when and just demand a clean site. Although lenders are more sophisticated these days about financing contaminated property, there will need to be a clear plan for addressing environmental issues and allocating appropriate responsibility.

2.14 Binding Future Port Commissions. Because these redevelopment projects can occur over a period of years, developers may seek assurance that if problems arise they will be addressed in certain ways. Developers may not appreciate that most commissions are elected and change over time when requesting a "side letter." Although the port is bound by signed contracts, it cannot provide assurances that future commissions will vote certain ways on later phases or implementation or act in accordance with certain understandings that are not reflected in the contract. Thus, the contract should be as detailed as possible to try to address future issues. "Working it out" in the future may not in fact work out the way the parties intended

when they put the deal together. This highlights the difficulty of contracts to be performed over many years and the inability of the parties to anticipate every circumstance that may come to affect the project, including changes in site conditions, markets, availability and cost of construction materials, zoning codes, shoreline permit requirements and public perception.

3. Private Developers—Their Issues

3.1 It's the Money. Developers are in business to make money, of course. Because they are taking considerable risk, they need to make a sizeable return. That is much harder to do these days—or at least it is harder to predict which projects will be home runs. Port property often features unstable soils and fill materials or is subject to height restrictions so as not to block water views—this limits the size of a project and the potential returns. The guiding principle of a real estate developer—to use as little of its own money as possible—should lead the port to explore how much “skin in the game” the developer really has (i.e., how much money it has at risk). Also, for each portion of the project, the developer is likely to set up a separate “special purpose entity” (and indeed may be required to do so by its lender) that only owns its piece of the project and has no other assets. If the project fails, what recourse will the port have to “deep pockets” (e.g., through guaranties)?

3.2 Well, Really It's the Lender's Money. Developers ALWAYS have financing. The parties have to make lender happy or there is no deal. So ports need to be prepared to deal with at least one third party lender. Lenders will not make land loans but will make construction loans when the project is entitled, permitted and ready to go. If the developer stumbles, the construction lender will have the right to foreclose and take over the project. This means that once disbursements start under the construction loan, the project will usually (but not always) drive to completion (a partially completed project is worthless), even if this is through the lender's efforts. Delay is inevitable, however, when the developer defaults. And if the default is due to bad luck in cost escalations, unforeseen conditions or a bad turn of the market, the project may need to be reconfigured to make it work. If the economics simply no longer pencil, the project may sit half-built for years as the lender works to bring in a new developer.

Because construction lenders do not come in at the start, and also to bridge the gap in funds that construction lenders will not provide (i.e., the equity requirement), a developer may have mezzanine financing. This is expensive money secured by pledges of beneficial interests in a constituent entity of the developer. The mezzanine lender is prepared to take over the project from the developer if necessary to protect its investment. An intercreditor agreement between the construction and mezzanine lenders delineates their respective rights.

3.3 Who Goes First/Risk Sharing. The first residential condominium project in a former brownfield/industrial area is a highly risky proposition. The developer will have an appetite for that risk but will be constrained by its lender. Personal guaranties on construction loans add to the excitement for the developer. To the extent it can, the developer will want to see the port in there sharing the risk (the very thing that the public rules are designed to prevent). The developer will want assurances that the port will be hand in hand with the developer,

building the pieces it is supposed to and selling bonds or collecting revenues to raise the money needed to complete the infrastructure in a timely manner.

The developer will be spending lots of its own money in the planning and entitlement process (which often does not get paid from financing until later), something that developers abhor. They will do this assuming that the remediation will be done and the infrastructure needed to build completed when they are ready to go. Further, the developer will expect a reward for taking the risk. Its contributions may have caused surrounding values to increase, making the consequences for its risk-taking a higher price to acquire another parcel. The developer may want to preserve some additional benefit for later phases as a reward for being the first to jump into the redevelopment.

3.4 Tax Issues. Careful attention to tax ramifications is primary in any deal structuring. The amount of a developer's return is dependent on the tax treatment of different components. Smart developers are always evaluating returns in tax terms. And, the tax rules are tightening. These are largely income tax oriented but property taxes may come into play (as discussed above). Also, if the port holds debt and the project is not successful, forgiving debt can have adverse tax consequences for the developer.

3.5 Promises, Promises. In exchange for committing to spend public money, the port should require assurances that the developer, as well as its successors, will perform. These may take the form of development agreements or other contracts binding the developer as well as the land. It is not enough to have the developer agree to stick to the plan. Thought needs to be given to the remedies if the developer does not perform. This inevitably intersects with lender concerns, and the port's views may not coincide with the lender's. In the process of tying up the land, the port may impose requirements that make the property difficult to finance, so developers need to be alert. For example, reversions or buy back opportunities may sound good to the port but are unpopular with lenders (who are concerned that the reversion will terminate the mortgage) and the public purse (unless the port has set aside the sale proceeds in a fund to repurchase the property, including paying off the mortgage).

Recorded development covenants are the preferred alternative. Performance of these covenants can be secured by a mortgage, but the mortgage will always be junior to the construction financing. Additionally, determining the "debt" secured by such a mortgage is problematic—it is essentially the cost of building the project but this is hard for the port to determine without detailed information. The port is unlikely to do the development itself. The main advantage of a mortgage is to have a say in how the project is transferred to a new owner. A better alternative might be for the port to have an option to repurchase the property, including all of the plans and permits that go with it, and then try to market the property to a new developer. This, of course, requires that the port have the funds to exercise the option (including paying off the construction and mezzanine lenders). Lenders need to get comfortable with these development covenants, which should be acceptable if they do not require a lender to develop but rather define the development if it occurs. Future owners would be required to comply with development plans, unless the port agrees to changes. Without this, the port has no assurance that the development it has invested to support will occur (if it does) in the manner intended. Note, however, executory contracts (e.g., development contracts) may be avoided in bankruptcy.

A port may also require personal guaranties, but these may be duplicative of the construction guaranties (meaning they may be of little use to the port but also that the developer may not mind giving them as they are already personally committed to completing the project). In the real world, personal guaranties are good for threats but are rarely enforced.

3.6 Parking. Parking is always a problem in these redevelopments. Parcel size is constrained (often by water on one side) and a high water table may limit excavation. It may be difficult to fit in a sufficient number of spaces. If underground parking is limited due to soils issues, above ground parking may be the only option, but this may be at odds with the desire for beautiful water views without looking through surface parking or garages.

3.7 Public Entity Blur. Developers often see all the public agencies involved in a redevelopment project—the city, county and port—as one. The developer may think that one approval should be good for all and definitely prefer one-stop shopping. In the real world, though, intergovernmental cooperation may be a goal but not a reality. For example, the city may control the permitting process, the state may need to issue a shoreline permit and the Army Corps of Engineers may also need to be involved. Many state and local agencies will need to be coordinated in seeing a project through to completion. A port who proactively manages the intergovernmental process will help speed the developer along to project completion.

3.8 Privacy. It is not unusual for developers to buy and sell properties under confidentiality clauses that prohibit public discussion of deal terms. And, of course, developers consider the details of their financial matters and returns to be private. Developers need to be educated that they are engaging in a public process and that is part of the deal. Between public meetings and FOIA requests, the public demands scrutiny. Developers need to appreciate that the documents placed in port files may not be private documents and plan accordingly.

3.9 Authority. A developer may have concerns about whether a port has authority to do the deal. Some of these redevelopments push the edge of a port's explicit authority and there may be a concern that port may not be able to follow through. Because authorizing legislation or an opinion from the attorney general may take too much time, counsel must concern themselves with structuring in a way that they feel comfortable is within the port's authority.

3.10 Media. Developers should have a strategy for presenting the project to the media and members of the public. They undoubtedly will attend at least the key meetings at which the project is discussed. There will always be critics of the project, ranging from those who think it is a waste of taxpayer money, those lobbying for special interests (e.g., Sea Scouts non-motorized watercraft dock, park and open space, cultural uses), those being “invited to leave” (e.g., polluting shipbuilders) and those protesting the height, bulk and aesthetics of the project. A media strategy that coordinates with the port's is best.

3.11 Insurance. Ports are often self-insured or insured through state programs. The usual requirements for the other parties to a deal to have insurance, as well as lender requirements, may be more difficult to satisfy. Requirements for agreed values for the site, payment of proceeds, minimum A.M. Best ratings and deductibles may be difficult to achieve

through a self-insurance or state insurance program. Developers need to understand how the port insures its properties and liability so that these issues can be addressed appropriately in the contract.

4. **Strategies for Tackling Public Private Partnerships**

4.1 Outside Counsel. Because these projects are so sophisticated, take enormous amounts of time to assemble and involve areas of law often outside the expertise of in-house counsel, engaging outside counsel is essential. Outside counsel should be experienced in both real estate development as well as schooled in the public issues. Hiring sophisticated counsel may mean the difference between a project that fares well in the rearview mirror and one that is an embarrassment in retrospect. Consider passing at least some of the costs along to the developer.

4.2 Hire Good Staff and Advisors. These projects are time sinks. When the deal and documents are in the heat of negotiations, and as closing approaches, the full time and attention of at least a few staff people are demanded. Piling this on top of other duties will result in staff not paying enough attention to the details and placing too much reliance on the facts and figures presented by the developer. Further, knowledgeable staff with experience in real estate development is critical, but these people should not be fresh from the private sector. Staff assigned to making the deal needs to be thoroughly educated about the rules constraining port authority. If the capacity is not found in-house, an outside financial analyst should be engaged to scrub the numbers and assumptions.

4.3 Beware Bedazzlement. If real estate development were easy, Donald Trumps would abound. The developer should not be allowed to bamboozle the project proponents within the port, putting stars in their eyes with promises of great returns. Real estate development is highly risky and takes vast amounts of money and staying power through market ups and downs. Developers are by nature optimists and sales people. The market is down right now—the port should ask itself whether, if projections are not met, can the port ride it out? It is important to plan for the worst because if it happens, the disaster (and waste of public funds) will ruin careers, toss commissioners out of office and be discussed in excruciating detail in the press. Careful consideration of the appropriate role for the public piece of the redevelopment is important—building infrastructure and encouraging private investment is all good but can cross the line if those responsible for the project do not have clear heads.