PUBLIC/PRIVATE PARTNERSHIPS IN A RECESSIONARY ECONOMY

Robert A. Thompson,
Sheppard, Mullin, Richter & Hampton LLP

Public private partnerships offer new real estate development opportunities for private developers and public agencies, and their respective lawyers. Three categories of such transactions can be identified, based upon the extent of "privatization" of development and operational responsibility and varying degrees of public use. At one end of the spectrum is the traditional redevelopment project, where the public agency facilitates private acquisition, development and use in return for compensatory public benefits. A more recent extension of the concept involves the private development and operation of structures for long-term use by public agencies (courthouses, jails and other governmental buildings and facilities). At the other end of the spectrum is the "concession agreement," which provides for private construction, operation and maintenance of facilities intended for use by the general public (toll roads, bridges, etc.). This outline reviews the business and legal issues associated with each of these public private partnership models.

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PUBLIC PRIVATE PARTNERSHIPS IN A RECESSIONARY ECONOMY*

Robert A. Thompson
Sheppard, Mullin, Richter & Hampton LLP
San Francisco, CA

I. Introduction

A. What is a public/private partnership?

1. In the most general sense, a public private partnership can be defined as a transaction that includes (i) various levels of use and control of a project by a public agency or quasi-public institution, (ii) with project development, ownership, financing, operation and/or management undertaken on the part of a private developer or consortium. Stated differently, a public private partnership is the shifting to a private entity of some degree of control and responsibility for development and operation of a facility to be used by the public, or for governmental or other institutional entity purposes.

2. This approach has been used for residential/commercial redevelopment, convention facilities, stadiums, entertainment venues, military base reuse, educational and health care facilities and other public and quasi-public institutional uses.

3. More recently, in the form of a "Concession Agreement," such arrangements have been used for the construction and long-term operation and maintenance by private developers of public facilities, such as public transit facilities, highways, toll roads, bridges and even municipal airports.

B. At least three basic categories of public/private development can be identified:

1. The traditional redevelopment model – where a public agency facilitates private ownership and use in return for negotiated public benefits and, occasionally, a profit participation.

2. The lease/leaseback model – where a public agency contracts for construction of improvements for use and occupancy by the same or another governmental or institutional entity.

3. The concession agreement – where a governmental entity contracts for development and private operation of public facilities for public use.

C. These and other models for privatization are intended to fulfill a variety of public purpose objectives:

1. For redevelopment - the elimination of blight, economic development, production of affordable housing and, more recently, economic profit sharing.

2. For lease/leaseback arrangements - public entity or institutional occupancy for governmental or institutional uses at lower cost and without the economic and other burdens of ownership.

3. For concession agreements - the design, construction and long-term operation and maintenance of public facilities at reduced or no cost to the public agency.

D. The perceived benefits to the public or institutional entity include:

1. Lower cost, greater efficiency and creative design: "faster, cheaper, better."

2. Higher quality project design and construction.

3. Long-term control of costs to user(s) (i.e., occupancy rent, tolls and public user fees, etc.).

4. Non-applicability of public contract law requirements.

5. Shifting risks of ownership and maintenance.

6. Privatization of financing.

E. These models encompass a variety of financing mechanisms and revenue sources as collateral, including:

1. High-credit occupancy leases.

2. User fees or tolls.

3. Periodic governmental payments.

4. Tax increment financing.

5. Public agency and §501(c)(3) tax-exempt bond financing.

F. Opportunities

1. From a lawyer's perspective, these projects call for expertise in real estate development, land use regulation, public agency and redevelopment law, eminent domain, construction law, municipal finance and bond financing and conventional lending, among others.

2. From the real estate client's perspective, these increasingly-popular approaches offer profitable opportunities to participate, frequently in conjunction with other members of a team, in a burgeoning area of real estate development, using skills and resources developed in the pursuit of private sector projects.

II. Basic Purpose and Structure of the Public Private Partnership ("PPP") Delivery Model

A. Threshold Distinction between Traditional Delivery Methods and the Public Private Partnership Approach.

1. Under the traditional design/bid/build approach, a public agency contracts for building design and construction, often through a statutorily-prescribed competitive bidding process. Upon completion of construction, the public agency or institution takes full ownership of the facility. There:

   a. The public agency is the developer, owns the project at the outset and has all obligations for maintenance and restoration of capital improvements and other expenses.

   b. The public agency also retains full control of design, operation and use.

2. Under a PPP approach, the public agency or institutional user (i) essentially dictates what will be built (through detailed specifications or, alternatively, a design build approach) and, (ii) upon completion, leases the premises itself or makes the facility available for public use, and either pays rent for its own use or makes periodic payments for public facilities, reflecting in each case the cost of development and a fair return on the developer's investment and operational costs. There:

   a. The developer is the long-term "owner" of the project and assumes some or all of the financial exposure for capital replacements, repairs, maintenance, etc., for the term of its tenure.

   b. Because of the extended involvement of the developer, the public agency's or institution's flexibility as to use or structural changes is constrained by its contractual commitments.

3. The PPP approach utilizes long-term conveyances of public agency or institutional land to the developer/operator. There are at least three variations:

   a. In the case of governmental use or occupancy, after initial transfer to a developer some or all of the improved space is leased back to the public agency (a "lease/leaseback"). Examples include courthouses, jails and other governmental buildings; educational and research facilities; and hospitals and other healthcare facilities.

b. In the case of private use, such as in a redevelopment project, the property is deeded or ground leased to a private party owner, who constructs and manages housing or operates commercial facilities, in each case eliminating blighted conditions and enhancing local property values and tax base.

c. In the case of a Concession Agreement, after completion of facilities under a lease or license, the improvements (e.g., a toll road, bridge, skyway or other public facilities) are made available for public use and financed by user fees or periodic governmental payments.

B. As an alternative to traditional methods of project delivery, a public agency or quasi-public institution using a PPP approach seeks the following benefits:

1. Limiting its financial exposure to entitlement and construction risks and, in some cases, market risk, and generally shifting to a private developer the economic obligations of development and ownership.

2. Streamlining the contracting process.

3. Timely and cost-effective development of facilities for use by the public entity itself, or benefited third parties, and lowering the overall cost of public agency or institutional use or occupancy.

4. Long-term control of (i) its occupancy and management costs and (ii) the reversionary fee ownership.

5. Obtaining access to specialized development and management expertise.

6. Obtaining the competitive benefits of a privatized development approach for cost effectiveness and high-quality project design and construction.

7. Incentivizing high-quality initial construction by placing long-term responsibility for operation and maintenance on the developer.

C. <u>Other Advantages</u>

1. Developers are typically chosen by a competitive Request for Qualifications and/or Request for Proposals ("RFQ/RFP") "beauty contest," based on the qualifications and resources of the prospective developer and the financial terms, project design and other, more intangible, aspects of the developer proposal, resulting in competitive cost and design creativity.

2. Provided that the risks and benefits of long-term ownership accrue to the developer, strict competitive bidding and other typical state Public Contract Law requirements often will not apply, allowing for contracting efficiencies and consideration of non-economic factors.

3. Project entitlements and compliance with state environmental disclosure laws are often within the jurisdiction of the participating public agency, thus, ideally, creating a regulatory as well as financial partnership.

III. The Concession Model

A. Basic Concept (see chart on page 8 below)

1. Instead of development, construction and operation of public facilities by a governmental entity, the developer or its successor entity constructs and maintains the facilities on a long-term basis under a lease or license.

2. Public improvements are privately financed on the basis of user fees or governmental payment obligations.

3. The typical structure for a concession transaction starts with a Design, Build, Financing and Operating Agreement ("DBFO") with the "concessionaire," normally a special purpose entity, which in turn enters into separate agreements with a builder/architect for the design and construction of the project and with a qualified management entity for operation and maintenance of the completed facility. Through contractual or joint venture arrangements, equity investors are recruited, and arrangements for financing, from a varied menu of possible resources (see Section IV.C. below), are undertaken.

B. Potential Benefits of the Concession Model

1. The public agency can negotiate and enter into a single agreement with one contracting entity, for finance, design, construction, operation and maintenance functions.

2. Such arrangements transfer risks and obligations to a private consortium that includes the developer, contractor, financing source, operations and management entity, etc. The private contracting party may be (a) a special purpose entity owned by the constituent role players (architect, contractor, equity investor, et al.) or (b) a developer entity that has entered into contractual or partnership arrangements with those other parties.

3. Taxpayers are protected from cost overruns, provided, of course, that private party commitments are reliable or adequately collateralized.

4. Accelerated project schedules and early completion incentives may be negotiated, beyond those normally included in conventional construction contracts.

5. Performance-based payments may be negotiated to increase the incentive to deliver long-term efficiency and reliability.

6. Private sector financing adds discipline and encourages innovation and efficiency.

C. Contracting Issues

1. For the public agency or institution, the primary agreement between it and the concessionaire must address issues that include the following:

    a. Who has the right to set rates or user fees, and to control other public use aspects of the facility?

    b. What are the appropriate payment obligations, schedule of performance, security for performance, and remedial rights, including "step-in" rights or termination?

    c. What are the appropriate provisions to cover changed circumstances over the extended term of the operating lease or license?

    d. What kind of guaranty or other collateral for performance can be provided for the duration of private ownership and operation?

2. For the Concessionaire:

    a. What provisions should be negotiated regarding risk allocation for unforeseen events, remedies for non-payment, design review, relief events, termination, liability caps, liquidated damages, bonuses, scope of warranties and warranty liability periods, etc.?

    b. How should obligations and risks assumed by the developer entity under the primary agreement with the public agency be allocated to the contractor, architect, financing sources, and other team members, and with what recourse for default?

3. For Lenders:

    a. Issues regarding suspension/termination of funding, additional security calls and financial covenants, step-in rights, and provision of information (reporting, inspection, etc. rights and obligations) may require unusual treatment, given the public agency's legal prerogatives and ultimate control and ownership.

    b. Normal remedial rights against the developer/operator, as well as special circumstances regarding public assets, need to be addressed in financing agreements.

4. For the Operator:

    a. Design review, construction oversight, liability caps, ongoing warranties of construction, etc. based on initial construction will have long-term relevance.

b. Management and other agreements for operation and maintenance require unusually extended and reliable protections (warranties and indemnities) from the initial contractors, architects, et al.

D. Legal and Political Issues

1. There may be a need for enabling state law for privatizing the construction, operation, management, and maintenance of public facilities.

2. Political and governmental realities may temper privatization efforts:

   a. Limitations sometimes exist on the availability of funds for long-term payments from various levels of government (e.g., procedural limitations under the Federal Highway Trust Fund, federal anti-deficiency appropriation constraints, etc.).

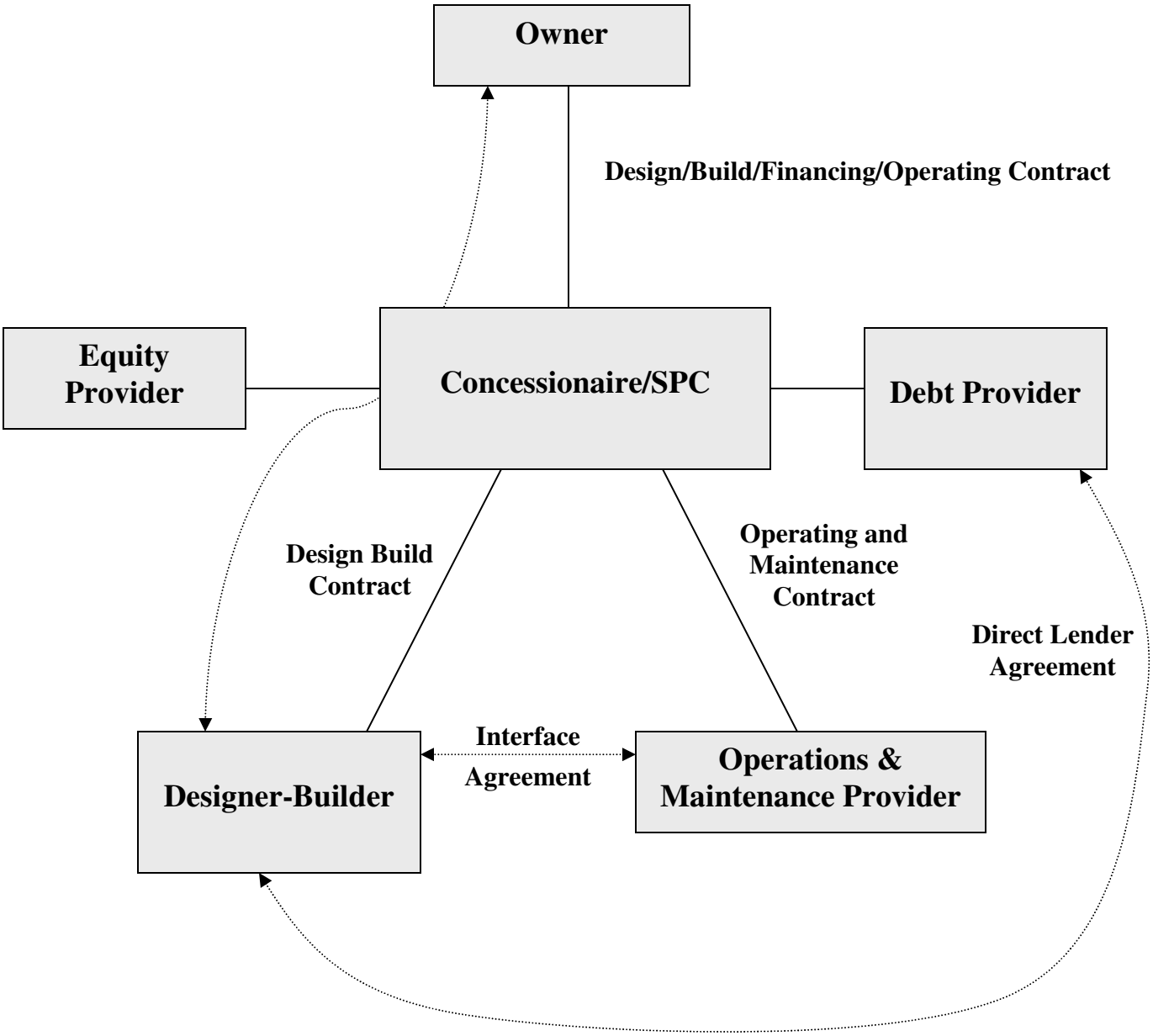
   b. Budgetary limitations and associated politics in a recessionary economy may lead to an abrupt termination of expensive and time-consuming contractual negotiations.

   c. The jurisdiction of elected and appointed governmental decision-makers may lead to policy shifts and negotiating reversals in the middle of a transaction.

   d. Local opposition to public infrastructure projects (e.g., freeways and toll roads) may lead to a greater risk of environmental or other litigation challenges.

3. When foreign concessionaires are involved, public perceptions may become important, if not determinative. For example, political opposition may exist with respect to sending profits overseas, but will compete with countervailing arguments in favor of foreign investment in the domestic economy, employment, etc.. In addition, the concept of foreign "ownership" of public assets, such as bridges and toll roads, can be controversial.

E. Typical Concession Agreement Structure**:



** With acknowledgment to Melody Pickett, Flatiron Construction Corp., Denver, CO.

IV. Lease/Leaseback Approach

A. Basic Concept (see chart on page 12 below)

1. Property owned by a public agency or institution is conveyed to a private developer, which constructs and leases the completed facility back to the agency or institution.

2. The developer retains the obligation for operation and maintenance of the facilities, as well as the benefits of a reasonable return on its initial investment and ongoing management services. At the end of the term of both the developer's "ownership" and the occupancy lease, the improvements revert back to the original property owner.

3. The process and transactional structures for a lease/leaseback vary, but typically involve a long-term Ground Lease from the owner of the project site to the developer, and a pre-negotiated, high-credit Space Lease between the developer and the public agency or institutional user. A Development Agreement among all parties governs the timing and scope of the developer's construction obligations; the Space Lease normally fixes the rent for the period of occupancy, and, where bond financing is employed, must be a high-credit lease obligation with a "hell or high water" rent start date.

4. Transactional issues include the adequacy of completion guaranties or other assurances, liquidated damages and other sanctions for failure to timely complete construction and deliver the premises, the scope and duration of warranties of construction, space lease rent adjustments, and the allocation under the Space Lease of responsibility for repairs and capital improvements, among other familiar landlord-tenant issues.

B. Key Drivers

1. Enabling state legislation is often required or helpful. (See, e.g., California's Senate Bill 4)

2. Market demand for the facility must exist for use by the public entity or other users to create a source of revenue; in either case, the revenue source must be sufficiently reliable to support public or private financing.

3. The economics of the transaction must support the availability of one or more of the available financing alternatives (see below).

C. Financing Alternatives

1. As noted, private financing is a function of a creditworthy source of long-term and reliable revenues.

a. A developer may utilize conventional, institutional construction and permanent financing.

b. Bond financing can be undertaken by a non-profit entity using § 501(c)(3) tax-exempt bonds, or other private bond financing.

c. Frequently there is a need for credit enhancement (e.g., bond insurance, institutional guaranties, or letters of credit).

d. The availability of equity will be a function of a reasonable and reliable return on investment.

2. Subject to restrictions on the use of funds, a public entity may make available to the developer the proceeds of:

a. Tax-exempt revenue bonds supported by lease rents or other user payments.

b. Until eliminated at the end of last year, Build America Bonds (BABS) were available to governmental and quasi-governmental institutions, which are taxable but are subsidized by Federal reimbursement payments to the bond issuer. It is unclear whether this program will be reinstated.

3. In most cases, the less expensive cost of public financing made available to a private developer creates economic advantages that may be appropriately allocated (by negotiation) between the parties.

D. Categories of developer risks (and mitigations) include:

1. The uncertainty of actual development costs, which is a risk borne by the developer because the already-fixed rent under the occupancy lease in effect creates a guaranteed maximum price construction obligation on the part of the developer.

2. Newly-discovered hazardous materials -- environmental insurance may mitigate this exposure.

3. Differing site conditions discovered during construction -- this risk is inherent in any construction contract and is likely to be resolved by familiar, negotiated compromises.

4. Earthquake, natural disasters, comparable events -- insurance provisions and relief for force majeure events are typical solutions for construction-period occurrences; however, these issues are more complicated with respect to post-completion events.

E. Negotiating Issues.

1. The issues to be addressed in the Development Agreement mirror many of those raised by the Concession Agreement (See ¶ III.C above).

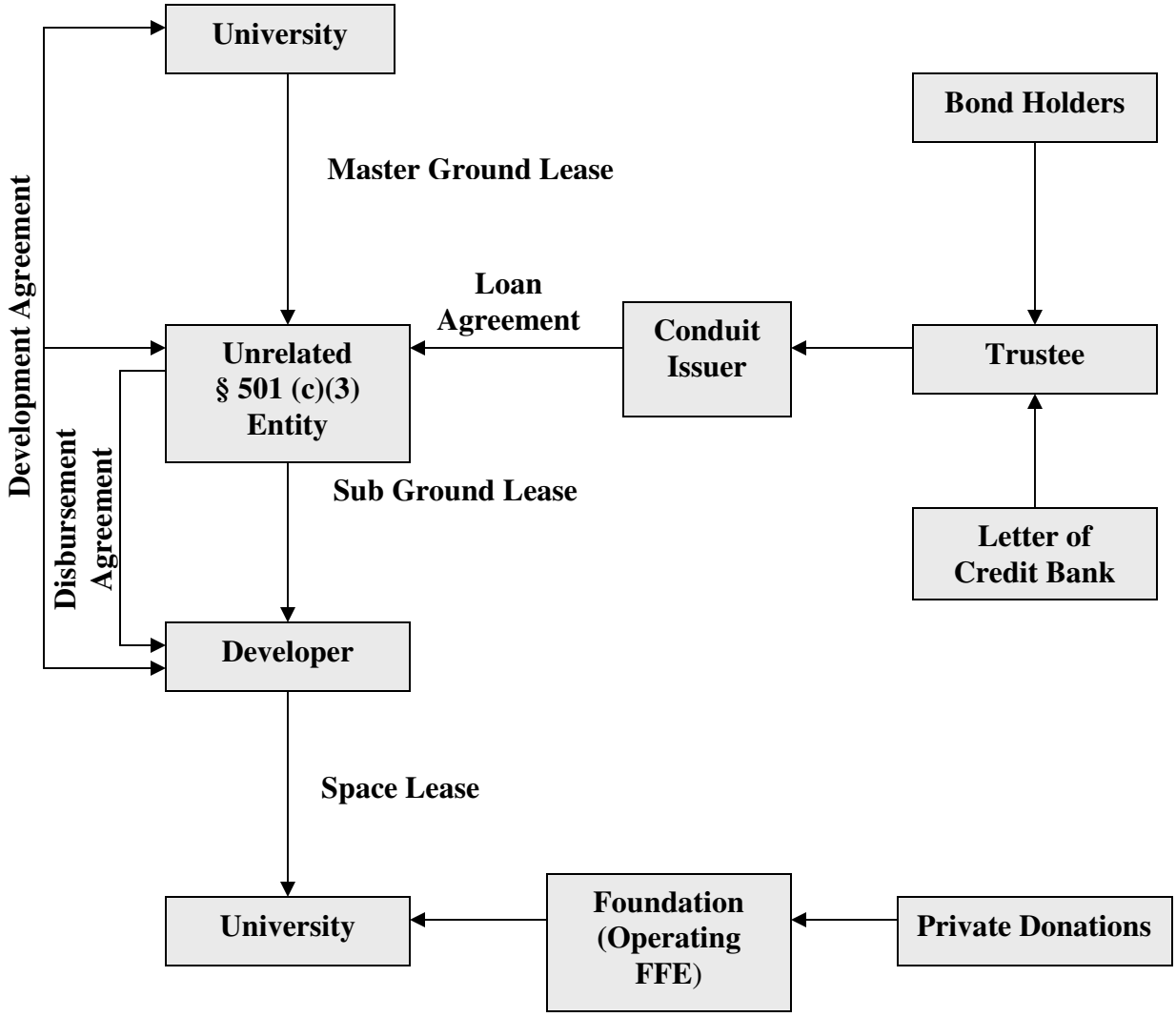
2. The Ground Lease and Space Lease raise issues related to the specific economics of the transaction, such as rent, rent adjustments, obligations for repairs and capital improvements, operating expense "pass throughs," change of use, and other familiar occupancy lease issues. Where the transaction is bond-financed using the space lease as collateral, alternative remedies to the tenant's usual right of termination for landlord default must be negotiated.

F. Lease/Leaseback of Existing Covenant Buildings

1. To raise immediate revenues to address budgetary shortfalls, some states, such as California, have sought to enter into sale/leaseback transactions with private investors, covering existing courthouses, office buildings and other governmental facilities.

2. These transactions simulate sale/leaseback financing arrangements long undertaken by private companies, but are not constrained by the requirement to comply with income tax and other regulatory considerations applicable to private transactions. They are relatively easier to negotiate and document than the development transactions described above.

G. Example of Lease/Leaseback University Transaction Structure:



V. The Redevelopment Model[***]

A. History and Purpose of Redevelopment

1. Redevelopment is perhaps the most venerable of PPP transactions. The modern redevelopment movement arose out of the "city beautiful" movement and the growing national awareness of urban blight. A model statute was created after World War II, some form of which has been adopted by most states.

2. Substantial federal support and funding for redevelopment activity occurred with enactment of the 1949 Urban Renewal Act, with the general objective of the physical and economic revitalization of decaying urban communities.

B. Redevelopment Agencies have at least three critical redevelopment powers (discussed below):

1. The power of eminent domain.

2. The ability to preempt local zoning regulations that conflict with an adopted redevelopment plan.

3. The availability of tax increment and other mechanisms for land-based financing.

C. Creation of Project Areas and Redevelopment Plans

1. As the first step in the redevelopment process, most state redevelopment statutes provide for the adoption of a "survey area," to permit study of a specified geographical area to determine, among other matters, if blight exists and the appropriate boundaries of a subsequently designated "project area".

2. Many statutes require the involvement of affected residents through an elected "project area committee."

3. The key component of the redevelopment process is the drafting and adoption of a redevelopment plan by the redevelopment agency commission and the local legislative body.

D. Eminent Domain

1. Many redevelopment agencies have, by state law, the power to condemn and acquire property for purposes of private development, under the general "public purpose" justification of the elimination of blight.

2. Recent state legislation and litigation has placed in question this longstanding right.

[***] With acknowledgment to David M. Madway, Sheppard Mullin Richter & Hampton LLP, San Francisco, CA.

E. Land Use Issues.

1. In most states, the jurisdiction of a redevelopment agency is established by state law; therefore, the legislatively-adopted Redevelopment Plan preempts conflicting provisions of local land use ordinances and regulations.

2. This does not mean that design and development are unregulated; the Redevelopment Plan is typically supplemented by an agency "Design for Development" document, which is at least as detailed regarding uses, densities, height and bulk, etc. as the typical local zoning ordinance, and which includes a detailed design review and approval process. Building codes and permit requirements usually remain subject to the local community's building department jurisdiction.

F. Land Disposition and Owner Participation Agreements (see chart on page 17)

1. Where property is owned or acquired by the redevelopment agency, a Disposition and Development Agreement (DDA) is entered into, which transfers ownership to the developer with obligations to develop the property under prescribed requirements, conditions and time schedules.

2. Where property is already owned by developer, obligations for development of infrastructure and vertical improvements are set forth in an Owner Participation Agreement (OPA), but normally without a time schedule for construction.

3. Consideration for either a DDA or OPA is often found in the requirements for compensating public benefits provided by the developer, such as the construction of infrastructure, provision of affordable housing, local hiring requirements and, occasionally, provision for profit-sharing.

G. Tax Increment Financing

1. Tax increment ("TI") is, simply stated, the increase in property tax revenues over those that existed in the year the redevelopment plan is adopted, known as the "base year." In many states, such as California, approximately 50% of the TI is available to redevelopment agencies; the remainder is dedicated for affordable housing and for pass-throughs to taxing agencies such as schools, community colleges, etc.

2. These funds can be made available to the developer for a broad range of activities, including, most importantly, the financing of new infrastructure improvements.

3. The redevelopment agency can either use TI to service bonds or it can make it available on an annual basis in the form of a periodic rebate to the developer of a portion of its property taxes, known as "pay-as-you-go".

4. Depending upon interest rates, tax-exempt TI bonds generally will produce a 10:1 ratio, so that a dollar of TI will produce $10 of bond proceeds; this ratio drops to

approximately 7:1 if the bonds are taxable. Thus, using TI for purposes that qualify the bonds for tax-exempt treatment is a significant advantage.

5. In most cases, TI bonds will need to be credit-enhanced, either with a letter of credit or with bond insurance.

6. Generally, redevelopment agencies will limit a developer's access to TI to the property taxes produced by its development; occasionally, however, TI can be "imported" from other portions of a project area.

7. TI is "late money;" that is, it is not available until the property actually has value, which usually means until it has been substantially developed (unless it is utilized to support bond issuance). On the other hand, TI is a "free lunch": the developer pays its regular property taxes, which are used either to service the TI bonds or to fund a partial rebate to the developer and, thereby, made available to finance infrastructure and other qualifying project expenditures.

H. Land Based Financing (Special Assessment Districts and Bonds)

1. An alternative or supplement to TI financing is known as "land based financing;" namely, the imposition of a special tax against property within the district benefited by the infrastructure improvements, the proceeds of which are used to service bonds issued by a newly-formed assessment district. In California, such financing is undertaken through the issuance of "Mello-Roos" bonds.

2. If, for example, the infrastructure built with proceeds from the sale of these bonds is a street that is to be publicly dedicated, then the bonds will qualify for tax-exempt treatment, with the beneficial leverage ratio described above for TI bonds; if the streets are not to be dedicated, interest on the bonds is taxable.

3. In California, there is a 2% limit on the combination of regular and special taxes, such as Mello Roos assessments, on residential projects; there is no such limit on non-residential properties.

4. Once value has been created, it may be possible to use the proceeds from the sale of the TI bonds (see above) either to redeem the assessment district bonds (depending on the call provisions of those bonds) or to defease them.

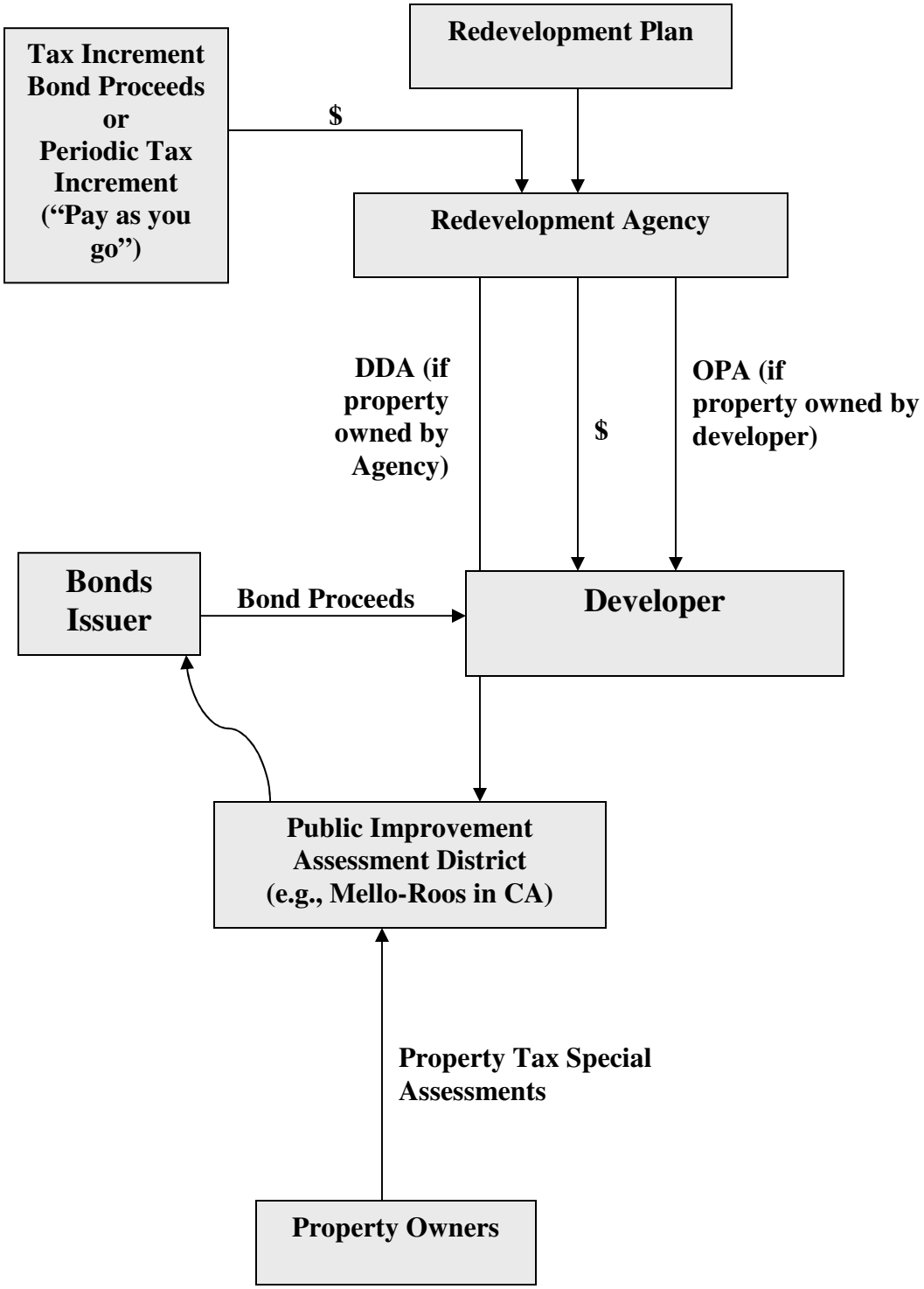
I. Other Development Authorities.

1. Many states have established special purpose agencies, such as port authorities, park districts, or industrial development districts, that have many of the same powers and limitations as redevelopment agencies. The federal government has chartered similar, wholly-owned entities with regard to military base reuse (e.g., the Presidio Trust in San Francisco).

2. These agencies are often precluded by law from conveying a fee interest in property to private parties. In those cases, long-term ground leases are conveyed

under a Lease Disposition and Development Agreement (LDDA), which raises familiar and sometimes challenging issues regarding development and financing of leasehold interests that must remain subordinate to the agencies' fee interests.

J. <u>Example of Redevelopment Transaction Structure</u>:



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