

NEGOTIATING THE MEGA-REBUILDING DEAL AT THE WORLD TRADE CENTER: THE INVESTORS' PERSPECTIVE

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I want to shift the spotlight away from the real estate deal with the Port Authority and away from the beautiful planning, design, and construction of the developers from the planning perspective, and focus on the internal issues within the Silverstein group. After September 11, as the earlier speakers noted, Larry Silverstein consulted first with his wife, second, with his lawyers—and third, with his investment partners. Like most real estate investments, Silverstein's World Trade Center investment was structured as a partnership between the operating partner and the financial partners. The operating partner, Larry Silverstein, has been very much the public face for the partnership.¹ The financial partners consist of a series of wealthy New York families, led by Lloyd Goldman, who are long-term New York real estate owners.² These financial partners remain more behind the scenes in terms of the partnership's operations.

In 2001, when the deal was consummated, the financial arrangements of the partnership provided that Mr. Silverstein and his group would invest one-third of the equity and Mr. Goldman and his group would invest the remaining two-thirds of the equity. The only significant difference between this arrangement and most real estate investments was that unlike most real estate transactions where the financial partner is an institutional partner, here the financial partners were a group of several families who came together as partners. These families were all long-term investors in New York real estate, which, in many ways, contributed to a harmonious relationship among the partners because they each had similar investment objectives with respect to each other and to the operating partner, Mr. Silverstein.

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¹ See generally Alex Frangos & Christine Haughney, *Lots of Tension, Few Tenants, 7 World Trade Center*, WALL ST. J., Dec. 15, 2005, available at <http://www.realestatejournal.com/regionalnews/20051215-frangos.html> (describing the partnership as Mr. Goldman being the “money behind” the “public face of Mr. Silverstein”).

² *Id.* (noting that Mr. Goldman contributed \$80 billion of the initial \$125 billion investment).

When the deal was first negotiated among the partnership groups in 2001, the nature of the investment was a very straightforward investment in an operating piece of real estate. The partners were coming together to use their equity money and leverage in obtaining the first mortgage loan and subordinate financing to acquire twelve million square feet of operating real estate. The investors' main concerns were focused on maximizing the value of that real estate such that as leases rolled over or new leases were put in place, rents could be raised and improvements could be made to the properties. Thus, the investment focus was very much on operating the properties and making management decisions for the long term. The risks that were being undertaken by the partners were simply leasing risks, and market risks that went along with any investment at that time. These risks included the concerns that Alex mentioned in his piece earlier regarding the health of Lower Manhattan's office market and the general risks of the financing markets, such as the potential fluctuation in interest rates and the ability to refinance in the future.

The original plan included the redevelopment of the retail space by a third party, the Westfield Group.³ As a result, the office space partnership was concerned with how the office space would increase in value from its interaction with and improvement of the retail space.

Based on the deal profile, which was a straightforward investment in operating property, the key concerns of the partners were negotiated in their original partnership agreement. There are key elements of the deal that always arise between operating partners and financial partners in deals. The first key concern was how the cash flow splits would be defined. Cash flow splits typically involve each party investing cash in the deal and receiving a return. This return is an internal rate of return typically calculated based on the party's invested money. After getting back the invested money, there is a back-end split. Typically, the back-end split gives a promote, an increase in the interest of the operating partner because it the one primarily managing the investment. The promote is the operating partner's financial reward for putting in the time, effort, and operating expertise required to make the investment a success and for the investors to get their desired financial return. Because this was operating property, the risk was considered quite low; therefore, the relative returns, the internal rate of return upon which the parties agreed prior to the back-end splits increased Silverstein's interest, reflected this lower risk and were also fairly low.

³ Press Release, Westfield Group, Westfield Group to Acquire Interest in World Trade Center Retail Facilities in Joint Venture with Port Authority of New York and New Jersey, Jan. 4, 2008, *available at* <http://globalrealestate1000.com/web/week/4143497-20080107-PR-westfield-group.pdf>.

The second key concern involved the negotiation of the leasing and management fees. In a complex of twelve million square feet with substantial leasing possibilities,⁴ both the leasing commissions and the management fees were likely to be quite substantial. The Silverstein Organization was handling all of the leasing and the management. However, because it is very important in a partnership that the partners' interests remain aligned as much as possible and tensions remain low, the partnership agreed to share the profits from the leasing and the management fees. The partnership did not want the leasing and management fees to create a situation where the operating partner cashed out his investment earlier than the other financial partners, which could potentially lead to a conflict of interests between the partners. Thus, the partners negotiated a sharing of those fees consistent with the risk and the activities involved.

Because the parties were individuals and real estate investors, there was a concern about sheltering current income. The ability to shelter current income during the early years of the investment was expected to be very substantial due to the tax treatment of the transaction.⁵ Section 467 of the Internal Revenue Code prescribes the way rent under leases is to be treated for tax purposes.⁶ When section 467 applies, this provision requires a straight-line treatment for rent deductions over the life of a lease.⁷ This tax treatment leads to a situation where, during the early years of the lease, the collective tenants under the ground lease were able to deduct a larger amount of rent than actually paid in cash. This result was very beneficial to all of the investors involved in the deal; thus, maintaining the treatment was critical.

Third, as Dara previously mentioned, Silverstein was seventy years old at the time that these buildings were bought; therefore, succession was a critical issue. A fourth key concern centered around which decisions could be made by the operating partner directly versus which decisions would have to be brought to the other partners for consent. Clearly, the rebuilding after a casualty was a material decision requiring the consent of the investor partners, which led the investor partners to remain shoulder-to-shoulder with Silverstein throughout the entire negotiation process.

⁴ See generally Dean Starkman & Peter Grant, *Rebuilding New York: Reaching a Consensus*, WALL ST. J., available at <http://www.realestatejournal.com/regionalnews/20011224-starkman.html> (noting that the twelve million square feet of office space will be rebuilt).

⁵ I.R.C. § 467 (2002).

⁶ I.R.C. § 467 (2002).

⁷ See *id.* For a general discussion of this I.R.C. § 467 and straight-line deductions in regards to business rent, see George Mundock, *Taxation of Business Rent*, 11 VA. TAX REV. 683 (1992).

Finally, another key concern addressed during the negotiations dealt with long-term investment holding periods. Interestingly, exit strategies for investors are usually one of the items most hotly discussed in a partnership agreement.⁸ Typically, exit strategies are important because institutional money always needs a way out of an investment.⁹ As a result, there are usually terms in an agreement that address forced sale of properties and other provisions governing sales of partnership interests. However, in this case, there was actually an alignment of interests; each party typically held its real estate for a substantial period of time and did not want the other party to be able to exit easily. The alignment of interests in holding the real estate in their portfolios for the long term probably contributed to why the parties were so persistent, and why the Port Authority found it incredibly important and desirable, to keep the Silverstein group involved after the World Trade Center disaster. Thus, instead of negotiating exit strategies, each party negotiated ways to keep the other party locked into the investment. Specifically, the parties negotiated a “lockout” where neither party could sell its interest for an extended period of time.

After September 11, 2001, the entire deal changed. For a number of years the focus was not on issues between the partners but rather on issues with the Port Authority. These issues centered on ensuring that the Port Authority would keep the Silverstein deal intact and permit rebuilding the World Trade Center, that the site control the partnership received from the Port Authority was sufficient, that the performance obligations for rebuilding were manageable, and that the insurance proceeds were split between the Port Authority and the Silverstein Group in a manner that would enable the office space to be rebuilt. The final result was a commercially viable and financially sound deal.

While the deal works from both the investment group’s perspective and the public’s perspective, it still raises a series of issues between the partners. Just as Martin described, the issues that arise in ground leases of existing properties are very different from the issues that arise in ground leases of development property.¹⁰ Similarly, a partnership agreement regarding existing operating property is much different than a partnership agreement for development property. Suddenly, the partnership agreement between the parties, which was tailored for the management

⁸ See generally Ohio Bar Association, Legal Basics Ch. 14, available at http://downloads.ohiobar.org/pub/LegalBasics/LegalBasics_ch14.pdf (discussing the importance and creation of exit strategies).

⁹ See generally John C. Coffe, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277 (1991) (discussing the importance of an “exit” for institutional investors).

¹⁰ See *supra* note 214 and accompanying text.

and operation of existing buildings, did not cover the variety of issues that needed to be addressed for a development project. Throughout the process, the partners were extremely focused on trying to preserve the original economics and the original relationship that had worked well; nobody wanted to take the deal back to the beginning. Nevertheless, there were some items that simply were not addressed in the original deal that needed to be addressed.

The first new issue was the question of development experience. Mr. Silverstein is a terrific developer and 7 World Trade is one of the most beautiful new buildings. However, a rebuilding project of this magnitude is not normally undertaken by a single developer. Thus, a key concern for the investing partners was ensuring that Silverstein's staff had sufficient development expertise. The question of succession also takes on a more poignant role. Because of the vast amount of activity to be done, the project requires a leader that has a personality with enormous charm and optimism like Mr. Silverstein's. However, Mr. Silverstein was now six years older than he was when he signed the original deal. The partnership had negotiated a succession deal that put in place a management committee of Silverstein's successors and the investor partners that would succeed him. Now that six years had passed, it was crucial that the partnership appoint that management committee and ensure it was ready to spring into action if necessary.

The next key issue after September 11 was to determine how to deal with the project economics and splitting the fee income. At this point, instead of having cash flowing from all of the investment properties, with the exception of insurance proceeds received and not otherwise applied to the Port Authority's ground rent, the partners are in a situation where there is no cash flow coming in from these properties other than the fees resulting from the redevelopment and leasing of the properties. As a result, the question of how the fees should be divided is now a very different question than it was in the original partnership agreement, because the fees are the sole economics of the new deal.

In order to effectuate a deal, it remained extremely important to maintain an alignment of interest between the parties. As Martin also mentioned, the rebuilding deal with the Port authority was set up such that each of the buildings, even as they are built, remain pledged to the Port Authority to support the obligation to complete the entire project.¹¹ This created a situation where the risk of completing the development falls not on the developer, but on the entire partnership. The Silverstein Organization was not delighted with this arrangement -- remember, the

¹¹ See *supra* note 115 and accompanying text.

fees and economics of a deal generally reflect the risks the parties are taking. Thus, unlike the original deal where Silverstein received the bulk of the fees for leasing and management services rendered, because of the risks that all parties were undertaking in the rebuilding deal and the fact that the fees would be the sole source of income for a time, the partnership agreed that all development and management fees – consisting of both those portions of the fees that cover the developer’s costs as well as the “profit” portions of the fees - would be divided in a manner that allowed Silverstein to recover the costs of Dara McQuillan, Janno Lieber, and the architects, and any additional amounts would be divided among the partners in the same manner as any other revenues earned by the partnership. Thus, the fees received by Silverstein are no longer treated by the partnership merely as fees for services rendered, but are now treated more as a partnership revenue source.

All of the post-September 11, 2001 issues were being negotiated by the partnership behind the scenes under the same time pressures and at the same time as the deal was being signed by the Port Authority. These negotiations were going on in different rooms and in different buildings, but were equally important and needed to be resolved before the necessary partnership consents would be granted to sign the deal with the Port Authority.