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A GOODWIN PROCTER PUBLICATION FOR THE REAL ESTATE INDUSTRY



Moving Forward, Looking Back

■ **Recession Lessons for Joint Venture Partners**

■ **Preparing the Modern Hotel Manager for the Midnight Raid**

■ **Borrowers Ask Lenders – Where’s the Love?**

■ **One Size Does Not Fit All in Real Estate Equity**

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Moving Forward, Looking Back

"Those who cannot remember the past are condemned to repeat it."– George Santayana, Early 20th Century Spanish American Philosopher

The real estate industry is likely very mindful of Santayana's words as it climbs out of the Recession and takes stock of the years ahead. Looking back and learning lessons from the past while confronting the future is the hallmark of a wise practitioner. But the process isn't easy, as investor Warrant Buffett notes:

"In the business world, the rearview mirror is always clearer than the windshield."

And with an unclear windshield, the tendency is to repeat the same mistakes, according to sociologist Marshall McLuhan:

"When faced with a totally new situation, we tend always to attach ourselves to the objects, to the flavor of the most recent past. We look at the present through a rearview mirror. We march backwards into the future."

On the other hand, there are those who suggest the past should remain a memory only, including motivational speaker Byrd Bagget:

"Look at life through the windshield, not the rearview mirror."

Like most things in life, when participating in today's real estate market, a balanced strategy is best.

As the authors in this edition of *REsource* show, the real estate industry is making adjustments in current conduct based on a sober appraisal of the most-recent past. Andrew Sucoff and Allison Driscoll provide recession lessons for joint venture partners, while Forrest Hainline and Teresa Goebel suggest some practical tips for luxury hotel managers to protect themselves from ouster. Dean Pappas and Jennifer Sung describe the impact of a tighter commercial lending market on borrowers, while John Ferguson offers a fresh look at equity capital relationships in light of the last four years.

While each article looks back, all are written for real estate practitioners as they move forward in today's market.

Moving forward, inspiration may be drawn by looking back at the words of gospel singer Kirk Franklin:

"The reason why your windshield is larger than your rearview mirror is because where you're going, is greater than where you've been. Go."

– Robert M. Haight, Jr.
Editor-in-Chief



by Andrew C. Sucoff and Allison Driscoll

Unprecedented disruptions in debt and equity markets over the last decade have strained many real estate joint venture relationships as partners faced unanticipated challenges. Difficult economic conditions stress-tested what were thought to be commonplace provisions of joint venture agreements. This article explores some of the lessons learned by joint venture partners who have faced a stubbornly depressed real estate market.

Addressing Additional Capital Needs

Funding unanticipated capital needs has been a common issue for real estate joint ventures as timeframes for stabilization lengthened and profitable exit strategies took longer to realize. Going forward, joint venture partners should reconsider whether familiar structures for funding additional capital sufficiently address the variety of scenarios that played out over the past few years. As an initial matter, the partners should decide which of them will have the right to call additional capital. In addition to traditional rights to approve capital calls by the operating partner, investors are increasingly negotiating for the affirmative right to call certain types of additional capital. One option for addressing

additional capital needs is tailoring funding obligations to the particular type of additional capital, based on the allocation of risk between the parties and whether the need for additional funds stems from one party's fault or circumstances beyond either's control. While requiring both parties to fund additional capital necessary for "preservation costs," such as real estate taxes, may be appropriate, the operating partner might be disproportionately or fully liable for certain cost overruns. The investor partner's funding obligation in this case might be (1) voluntary, (2) mandatory but subject to a cap, or (3) mandatory but only after the developer funds a minimum amount. In addition, the investor partner may receive capital account credit for its contributions for cost overruns, while the operating partner is credited for only some or none of its contributions.

The parties should also reconsider the implications of failing to fund with an eye toward aligning remedies with the nature of the underlying funding obligations. For example, certain failures to fund might trigger changes in management in addition to the performing partner's traditional right to squeeze-down the defaulting partner's percentage interests or to fund needed capital as loans.

Allocation of Guaranty Liabilities

Dramatic shifts in debt markets have also led to unanticipated liabilities as required LTV ratios have fallen significantly, extension rights have become contingent on satisfaction of increasingly austere financial covenants, and guarantor financials have come under harsh lender scrutiny. Joint venture agreements for development projects typically contemplate completion and payment guaranties in connection with construction financing but often fail to anticipate the scope of future guaranties that lenders may require.

To the extent possible, the parties should agree up-front which of them bears responsibility for required loan guaranties. However, just because the parties agree that one will be responsible for a particular guaranty, does not mean the lender will consider that party acceptable. Contribution agreements between the partners or other compensation mechanisms such as providing capital account credit for liabilities actually incurred may be necessary to address this disparity.

Also consider potential misalignments between debt liabilities and management rights. A developer partner that gave a payment guaranty might rightly object to its investor partner having the unfettered right to cause the venture to default on its loan obligations. Partners can also minimize some risks by negotiating with lenders for provisions to reduce or terminate guarantor liabilities upon achievement of certain benchmarks and other rights, such as the ability to replace a guarantor to avoid an imminent breach of financial covenants.

Management Rights and Dispute Resolution Mechanisms

It is particularly crucial to balance theory with practical realities in formulating management rights and dispute resolution mechanisms. While investor demands for increased management rights are understandable in the face of heightened risk, shifting control away from the developer partner to the investor partner may do more harm than good if the investor partner is not equipped to properly exercise these rights. In the absence of developer malfeasance, the investor partner should consider whether assuming operational control is really the best approach to limiting risk.

Reformulating the traditional list of “major decisions” to provide for greater oversight by the investor partner is one option for aligning rights with risk without sacrificing operational efficiency and expertise. By negotiating for the right to initiate major actions rather than just an approval right with regard to actions proposed by the developer, an investor partner with much to be gained or lost can ensure that it won’t be hamstrung by a partner who is effectively out of the money.

If decisions require the unanimous consent of both parties, special attention should be paid to structuring dispute resolution mechanisms. The arbitration process contemplated by many joint venture agreements may be an unsatisfactory means of resolving disputes over discretionary matters. If, for example, each party favors a different resolution to a design issue, an arbitrator’s decision to split the difference is unlikely to satisfy either of them. Exit rights triggered by intractable disagreements may be an equally unappealing solution, particularly in the midst of a down



“Reformulating the traditional list of ‘major decisions’ to provide for greater oversight by the investor partner is one option for aligning rights with risk....”

market. As a result of the inadequacies of traditional dispute resolution mechanisms, investor partners are increasingly demanding the unilateral right to make many major decisions, and this trend can be expected to continue.

Exit Rights

Structuring exit rights to be consistent with the intentions of the partners is another important component of preparing for unexpected economic events. Since the exercise of exit rights typically coincides with a divergence between the parties’ interests, the parties cannot assume an alignment of interests will exist to facilitate the process. Parties should be on the look-out for “gaming” opportunities that unfairly advantage either party. For example, disparities in access to capital may undermine the inherent check built into a buy-sell mechanism that allows the initiating party to specify the asset value on which the purchase price for each party’s interest will be based. In addition, practical

impediments, such as tax structuring issues, may diminish the actual value of a given exit right. Here too, the parties should consider whether certain rights should arise, expire, or evolve in response to different triggers, including shifts in the parties’ relative exposure, defaults by one partner, and external circumstances beyond either party’s control.

As the real estate sector recovers and joint venture relationships again proliferate, both sides will be reconsidering the terms that have governed past arrangements as a result of the painful lessons learned during the prior cycle. Going forward, joint venture partners can significantly improve their ability to successfully weather periods of uncertainty and depressed demand by recognizing that unexpected costs and other liabilities will likely arise at some point during the lifetime of any real estate investment. Formulating rights and remedies that are likely to be both practical to implement and adequate to address potential shifts in the relative positions of the parties will continue to be a challenge. However, by considering a broader and more nuanced range of approaches to significant issues and focusing on aligning each party’s obligations and liabilities with its management rights, remedies for breaches by the other party and exit rights, joint venture partners can improve the likelihood of striking the right balance between protecting their individual interests and promoting the aims of the venture. ■

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Preparing the Modern Hotel Manager for the Midnight Raid

by Forrest A. Hainline III and Teresa K. Goebel

There is a virus infecting the luxury hotel industry. Some over-extended hotel owners with illusions that the grass is greener believe the answer to their financial troubles is to ditch their current managers and either self-manage (eliminating third-party management fees) or replace them with managers willing to pay the owners to pitch their flag at the hotel.

Woolley and its Progeny

Relying on the 1991 *Woolley v. Embassy Suites* case and its meager progeny, owners believe they can terminate their hotel management agreements at any time, regardless of the terms of any agreements between them and the hotel manager. In *Woolley*, the court allowed an owner to terminate a long-term hotel management agreement without any contractual basis for terminating, relying on the common law concept that a principal (here, a hotel owner) has the power to terminate an agent (a hotel manager) at any time, regardless of the terms of any agreement between them, subject only to payment of damages for wrongful termination.

Recently, some hotel owners have resorted to the surprise midnight raid, effectively ousting their hotel managers in the middle of the night, rather than follow the dispute resolution process stipulated in their agreements. For example, the owner of the Aviara Resort and its security guards and locksmiths descended upon the former Four Seasons Resort Aviara for an attempted midnight takeover. In late August, the owner of the Waikiki Edition took over the hotel early on a Sunday morning, the same day that the Turnberry owners and their guards took over the Fairmont Turnberry Resort. In each case, the owner attempted to oust the current manager without notice, seeking to remove high-level employees of the existing management company (sometimes forcibly), install their own managers, and change the branding of the hotel. Two of the raids – Waikiki Edition and Turnberry – were successful; the attempted Aviara takeover was not.

These midnight raids seek to create a new *status quo* that the “outlawyers” hope courts will be reluctant to undo, rather than bringing the matter to court or, preferably, arbitration in the first instance to

determine whether removal of the manager is appropriate and if so, under what conditions. Practically, these midnight raids create confusion and disorder in the hotel, undermine guest expectations, threaten hotel managers’ relationships with vendors, travel agents, meeting planners, guests, and other stakeholders, and expose managers’ trade secrets and other proprietary information to unauthorized pilfering by the owners and their cohorts – all to the detriment of the hotel managers and their brand.

Lessons Learned

In all attempted takeovers, the most critical path for the hotel manager is to stay in possession. This allows for three things. First, on any motion in court for a preliminary injunction to remove the manager, the owner would have the burden of satisfying the stringent preliminary injunction standard (likelihood of success, irreparable harm, no adequate remedy at law) and should have to post a bond. Second, if the management agreement has an arbitration provision, the management company can go to court to prevent the owner from taking any action that would interfere with the arbitrator giving complete and effective relief. Third, in the event that it is determined that the owner may remove the hotel manager, the transition will occur in an orderly fashion that protects the interests of the various stakeholders in the hotel. Importantly, under most state laws, arbitrators are not required to follow “dry law,” but are required to follow the parties’ agreement. If an arbitrator refused to follow the parties’ agreement, the arbitrator would be acting in excess of his or her authority and the award would be subject to being vacated under either state law or the Federal Arbitration Act.

In addition to staying in possession of the premises, there are several lessons a management company can learn from recent takeovers to protect itself from breaches not only of management agreements, but also breaches of the peace.

- Most hotel management agreements contain covenants of quiet enjoyment. In most cases, they also provide that the manager cannot be removed without an arbitrator or a court making the determination. Every front desk manager – especially those on the night shift – should understand these important rights and have copies of these provisions at hand at all times.
- A management company should have, for each hotel, a private security company with a close relationship with the police that can be called and that will respond quickly

if a midnight raid should occur. Every front desk manager should have this number easily accessible. The security company should be instructed that under the hotel management agreement, the manager has a right of quiet enjoyment that makes unauthorized entry by the owner and its minions a trespass. If a midnight raid occurs, the security company should be quickly summoned and the police called. During the Aviara Resort raid, the police were called, and did not allow the ouster of Four Seasons.

- The front desk manager of a hotel under an owner siege should demand that the police remove the trespassers or be subject to arrest.
- Following the attempted takeover at the Aviara Resort, Four Seasons also went into court to obtain a temporary restraining order against the owner’s efforts to remove it as manager. The court prevented the takeover and sent the matter to arbitration. Every desk manager should have at hand to call – after the security company is called – the management company’s general counsel and outside counsel. He or she should have several names to insure that one is reached, even at three in the morning.

Return to Rationality

Even in cases decided in court rather than arbitration, at some point, a rational judge will see that sophisticated hotel management agreements, which comprise the principal assets of both private and public hotel management companies, are not trumped by common law ideas originating with the owner of a cow hiring another to care for it. At some point a rational judge will recognize that just as ordinary Americans can waive the most sacred constitutional rights, such as the right to a jury or to an attorney, so sophisticated parties can waive common law principles and agree that their agreements mean what they say. But in order to even reach such a rational judge – or enforce a contractual right to have an arbitrator resolve the dispute – management companies in today’s world have to prepare for the outlaw, the outrage, and the disorder of the midnight raid. ■

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by Dean Pappas and Jennifer Sung

The unavailability of credit during the past several years resulting from the virtual disappearance of the CMBS market, severe impairment to bank balance sheets, and the downturn of the commercial real estate market generally has altered standard lending practices and the lender/borrower relationship. Gone are the days when lenders undercut one another for mediocre deals (at least for now), and once again the person

Borrowers Asking Lenders –

who holds the purse dictates the terms. Although the shift in leverage from borrower to lender has varying ramifications depending on the quality of particular deals and the creditworthiness of particular borrowers, every commercial borrower in today's market should expect certain fundamental changes from the commercial lending market of four years ago.

Underwriting Standards

Stricter underwriting standards prevail for all types of loans manifested most notably by lower loan-to-value (LTV) and loan-to-cost (LTC) ratios. Typical LTV ratios for both permanent mortgage loans and construction loans now range from 50% to 65%, well below the 80%-plus range that was prevalent in 2006 and 2007. Some lenders are also limiting their borrowers' overall leverage and/or otherwise restricting or prohibiting junior indebtedness, including mezzanine debt. The reduction in LTV/LTC ratios and other restrictions on leverage have left a large gap in the capital stack to be funded by equity or, to the extent permitted by the loan documents, equity-type financing (e.g., preferred equity or mezzanine debt).

In addition to the reduction in LTV/LTC ratios and other restrictions on leverage, lenders are seeking stronger credit to support recourse obligations under their loans, such as completion guaranties, recourse carve-out guaranties, and environmental indemnities. Specifically, lenders are imposing higher net worth and liquidity requirements.

Often, the sponsor or developer in a joint venture relationship is unable to satisfy the lender's credit requirements,

leaving the capital partner as the sole or joint source for the recourse obligations under the loan. Of course, the provision of guaranties by the capital source will often result in material changes to the terms of the joint venture arrangement, including increases to the capital partner's preferred return rate, reductions to promotes, and the negotiation of comprehensive contribution and indemnification agreements among the partners. Moreover, in order to mitigate its risk, the capital partner may negotiate for additional management rights over the business of the venture and the day-to-day management of the real property. For many capital providers, these additional management rights may significantly strain their limited human resources.



Co-Lender Arrangements

Without a vibrant secondary market in which to sell commercial mortgage loans, loan originators are faced with the reality that they may be forced to hold the loans that they originate on their balance sheets. In order to diversify and mitigate risk, many lenders are seeking additional capital from other lenders via co-lender and participation arrangements. In fact, today most large commercial mortgage loans are funded through co-lender arrangements.

This increase in co-lending arrangements results in an interesting dynamic between a borrower and its co-lenders.

“Where’s the Love?”

Co-lenders that do not act as the administrative agent have begun to demand more control and approval rights not only over the loan negotiations but also over loan administration during the term of the loan. These control/approval rights may greatly impact and even hinder a borrower's operations.

A borrower may now need to obtain approval from multiple lenders for many day-to-day decisions and events such as leasing, management, and internal transfers within the borrower. Moreover, each lender in a co-lender arrangement may have very different concerns and may be in a different financial condition from the other lenders. Taken to an extreme, co-lender arrangements that require the approval of all lenders for every approval under the loan documents may stifle a borrower's business. These provisions may become particularly problematic in construction loans where delays in lender approval can significantly impact the project's timing and cost. Surprisingly, lenders have become very resistant to any comments to the co-lender provisions of the loan agreement.

Co-lenders are also now actively involved in negotiating loan documents up-front. Even when working from precedent documents between the borrower and administrative agent, co-lenders have begun to significantly comment on basic precedent provisions that would previously have remained intact (e.g., shortening or otherwise limiting notice and cure periods). The active participation by all co-lenders in the initial loan document negotiations often complicates and delays the loan closing process, thus a borrower should factor the impact of the co-lender dynamics into its timing expectations.

The co-lender arrangement raises unique issues in construction financing and other loan arrangements that include future funding obligations on the part of the lenders. Typically, co-lenders are severally obligated to fund their share of the overall loan principal so that no single lender is obligated to fund more than its percentage share of the principal. When fundings are to be made by the lenders after the initial loan closing, the borrower must consider the identity and creditworthiness of each lender and the impact of a funding failure by any one lender.

Even when the initial co-lenders are adequately capitalized to faithfully discharge their funding obligations under the loan, the borrower should be cognizant of any permitted

transfer provisions allowing a lender to transfer its loan and obligations to an “eligible assignee.” If the eligible assignee definition is not carefully negotiated such that co-lenders may transfer their obligations under the loan to virtually anyone, an inadequately capitalized lender may acquire a piece of the loan, whereupon the borrower may face the real risk of a funding failure.

If a particular loan requires future fundings from the lenders (such as a construction loan), the eligible assignee definition should include an objective standard to ensure the creditworthiness of each lender that holds a piece of the loan. For example, an eligible assignee must be an entity that is in the business of making commercial loans with assets or a net worth in excess of a certain threshold amount.

A Shift in Leverage

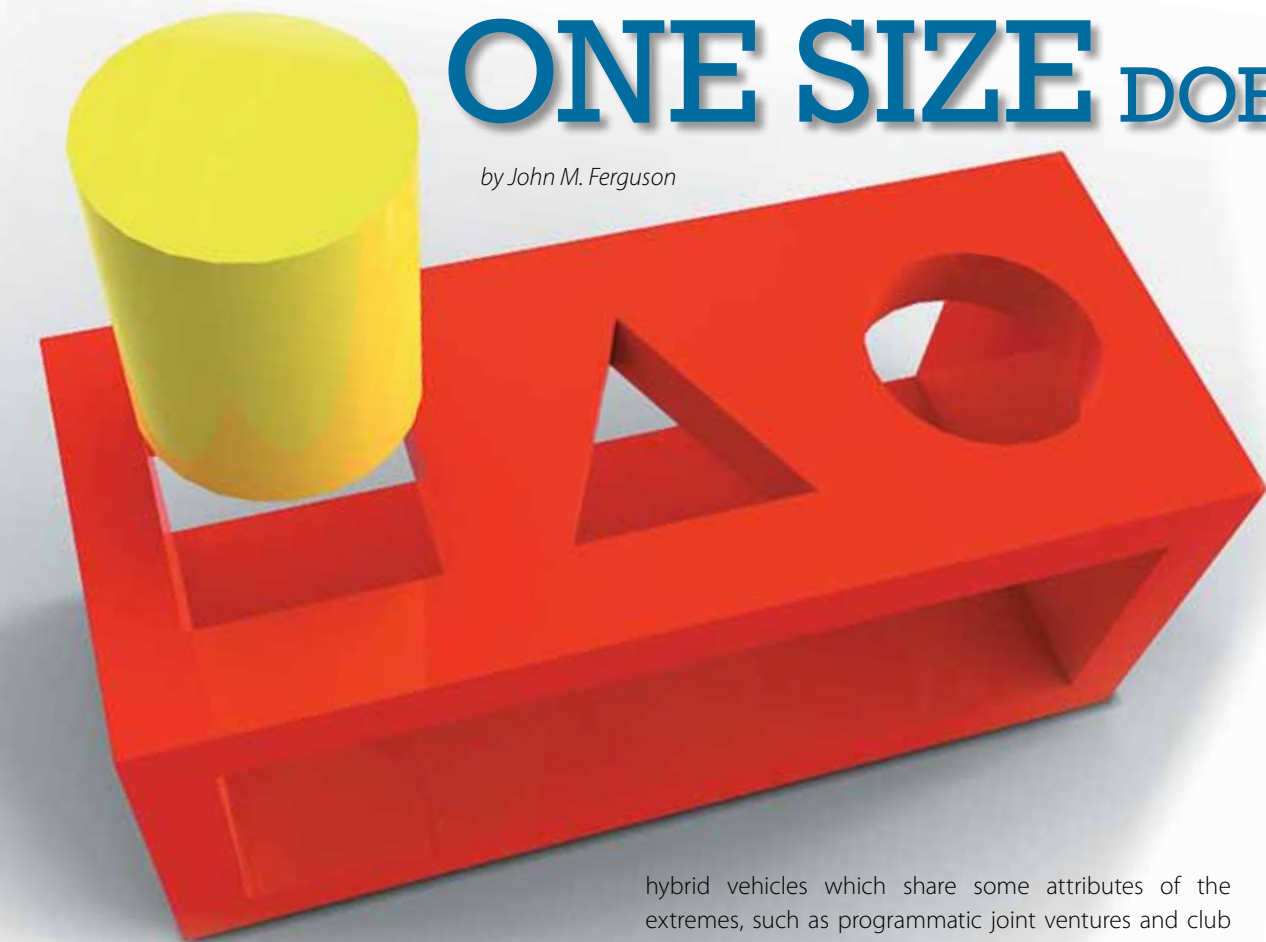
The commercial lending market has changed significantly over the course of the past several years. As credit dried up, lenders have begun to tighten their underwriting standards and take back much of the leverage held by borrowers during the “boom” times. Consequently, borrowers must now tread carefully, understand the shift in the market, and thoughtfully consider the potential ramifications of every term and provision of their financing transactions. ■

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ONE SIZE DOES NOT FIT ALL IN REAL ESTATE EQUITY

by John M. Ferguson



One consequence of the hangover following the real estate market's post-Millennium over-indulgence is that many partygoers have become more self-reflective. Many real estate investment managers and their institutional investor clients seem more thoughtful about the pros and cons of the different relationship constructs for raising and deploying equity capital.

Admittedly, a fair bit of the introspection is being driven by market forces. A manager's inability to raise a new fund or an institutional investor reacting to its latest legacy portfolio headache can be powerfully sobering. Nonetheless, even if seemingly forced upon an investment manager/sponsor by limited choices, a thoughtful approach is prudent as all constructs are not created equal.

The Equity Capital Spectrum

Structures to marry capital with real estate investment opportunities can take a variety of forms, each with its distinct advantages and disadvantages. At the most basic end of the spectrum is the single property joint venture, and at the far, more complicated end is the discretionary commingled private equity-style fund. In between are

hybrid vehicles which share some attributes of the extremes, such as programmatic joint ventures and club arrangements.

While ultimately each vehicle and deal is negotiated and unique, certain traits appear frequently enough to afford a general "market" framework. Key metrics include: the level of commitment the sponsor (general partner) and the capital source (investor) make to one another; sponsor autonomy versus investor control; and sponsor remuneration. And it is not uncommon to see a progression of choices.

Joint Venture. The traditional joint venture involves a sponsor finding and tying up a deal, and then securing the equity (and debt) capital to allow it to complete the purchase. The sponsor does the legwork to find the opportunity and then, in a classic chicken-and-egg situation, either goes at risk to secure the deal or risks losing it while seeking to "backfill" its capital. For bearing this risk, the sponsor has no pre-existing commitment to any particular capital source. Once closed, the parties remain in the deal until they mutually agree to exit or break an impasse by triggering a buy/sell, put/call, or other forced exit right.

Typically, the sponsor will receive fees based on invested capital from and after the closing and a disproportionate sharing of any upside once one or more return hurdles are

achieved. On the upside, each transaction's economics are done on a stand-alone basis which means successes are not tempered by other performances within a portfolio. And, this is the trade-off for the sponsor expending its own time and resources, without any management fee or other income, to source the transactions without certainty of capital, and to undertake sourcing capital for each new transaction.

Programmatic Joint Ventures. Many successful one-off joint ventures lead sponsors and capital sources to repeat business. Once parties have negotiated their first set of terms and become comfortable with one another, there is efficiency to be gained. Under a programmatic joint venture, a sponsor agrees to exclusively present all opportunities within parameters (e.g., deal size, property type, investment strategy) to the capital source. In exchange, there is an expectation (though usually short of a firm commitment) that the capital source will fund proposed deals. While risk remains that a proposed transaction will be vetoed or the capital source might default after committing, the sponsor's risk of not having available capital is reduced.

Like a single property joint venture, management or other fee income tends to be on invested capital; but, the sponsor's disproportionate sharing in the upside returns in excess of return thresholds are typically portfolio-wide across all program deals, often implemented with a distribution test and clawback.

The sponsor's trade-off for more certain capital is its promise to bring the transactions to its one source of equity capital.

Club Deals. Sponsors desiring the attributes of a programmatic joint venture, yet wanting to reduce veto and default risk associated with a single capital source, may move further to the next broad category of relationship structures: the club. A typical club arrangement has all the attributes of a programmatic joint venture, but with multiple investors. The sponsor assembles a consortium with loose commitments to participate.

Multiple investors able to opt-in or -out on a deal-by-deal basis often introduce an added level of complexity. Structuring the investment of institutional capital into U.S. real estate is largely driven by the types of investors (e.g., U.S., non-U.S., taxable, tax-exempt, pension plan, government, subject to various regulatory regimes) and the investment

strategies. By bringing multiple investors together, not all of whom may have the same profiles, the composite of capital and resulting structure often becomes more complex. Doing so for each individual transaction once investors have opted-in (and the participating group may differ for each deal) has the potential to give up some of the efficiency afforded by standby capital on known terms.

Those with the ability to raise institutional capital from multiple investors willing to cede deal-by-deal opt-out rights may consider the next step in the structure progression: the discretionary commingled private equity-style fund.

Funds. In a fund, investors typically lock up their capital for eight to ten years by making commitments, which can be drawn by the sponsor during the first three to four years. The sponsor customarily receives a management fee on committed capital during the three to four year deployment period, and thereafter on net equity invested during the hold and harvesting period. Profit sharing with the sponsor is typically portfolio-wide across all investments in the fund.

While more expensive on the front end and more time consuming to raise than a club deal or a programmatic joint venture – often taking 12-18 months from commencement of marketing – the sponsor has discretionary capital, and assuming a broad enough mix of investors and adequate default remedies, certainty of deal execution. Also important and typically not present with the less discretionary joint venture, program, or club capital is discretion for the sponsor to hold and exit when it sees fit. This affords the sponsor greater control of its upside profit-sharing by eliminating the risk of being forced (e.g., via a buy/sell) to exit prematurely.

What Construct is "Best"?

As is often the case, the upside in one area typically comes at the cost of a downside elsewhere. Raising equity capital for real estate in the private markets is no exception. One size does not fit all. Ultimately, the "best" construct for raising capital depends on who you are, your priorities, and last but not least, what capital is actually available to you as dictated by market forces at a particular time. ■

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