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Q&A With Arnold & Porter's Carey Smith

Law360, New York (December 14, 2011, 2:09 PM ET) -- Carey Smith is a partner in Arnold & Porter LLP's Washington, D.C., office. He negotiates and documents sophisticated joint venture, private equity, debt placement and similar arrangements for clients in various lines of business, primarily in the development, ownership and disposition of commercial real estate.

Given his experience in the tax and real estate fields, he is able to represent a client in all aspects of a complex real estate development transaction. He also has experience in the tax and transactional issues involved in debt restructuring, recapitalization, and other distressed asset situations.

Smith has a particular focus in the hospitality sector, representing primarily owners and developers of hotel properties.

Q: What is the most challenging case or deal you have worked on and what made it challenging?

A: I recently represented the sponsor of an existing joint venture in a recapitalization that involved bringing in a new (second) equity partner, refinancing the existing mortgage loan indebtedness with a new lender and issuing a carried interest to the prior lender.

This deal was challenging because of the sheer complexity — the property was an office park with 21 separate parcels, which were wholly owned by the existing joint venture, except for one building in which an interest was owned by the lead tenant. The original mortgage loan was made in 2007 and, due to the market swoon, there was no hope of refinancing the entire balance when it matured.

Our client was able to pull together a recapitalization that included the following elements: payoff of the original mortgage loan at a discount, with the issuance to the existing lender of a carried interest in the event that the restructured venture is very successful; obtaining a new mortgage loan, at a lower principal amount, from a new lender; bringing in a new institutional equity investor to infuse additional equity; modifying the original joint venture with the existing institutional equity investor to accommodate the new deal; and structuring the transaction to avoid cancellation of indebtedness income.

This required the simultaneous negotiation of three separate joint venture agreements and a new set of loan documents, as well as real estate transfer and related matters for 21 parcels.

The most challenging single issue was no surprise, as it seems to recur with increasing frequency in the last few years. It is difficult to allocate responsibility among several joint venture partners for the springing liability that may occur under a mortgage loan, particularly in the case of a voluntary bankruptcy filing.

Lenders and institutional equity partners generally try to focus this risk on the sponsor, but there are numerous scenarios where the sponsor does not have the necessary control to avoid triggering liability. We've seen this primarily where mezzanine lenders or equity partners have certain rights to take control of a property and the entity that owns the property, but it is not that easy to get the sponsor released from the springing recourse guaranty in that case.

Q: What aspects of your practice area are in need of reform and why?

A: We need a new, coordinated and multijurisdictional approach to real estate development that will achieve the best results for the public sector and help smooth out the boom-and-bust cycles for the private sector.

In most metropolitan areas, we have multiple subjurisdictions that compete with each other for users and the tax dollars they bring, as opposed to a coordinated approach that transcends local jurisdictions and directs development to where there's existing infrastructure and human capital.

This has all sorts of negative consequences, such as increased infrastructure costs, traffic and pollution, and unnecessary public subsidies for private development. It also exacerbates boom-and-bust cycle that seems a fact of life in the commercial real estate market.

Q: What is an important issue relevant to your practice area and why?

A: After narrowly failing to pass a change in the taxation of "carried interest" in 2010, Congress is once again flirting with the idea of dramatically changing settled partnership tax law, as a way to score political points and raise a small amount of revenue.

In general, the proposed change would tax all income or gain attributable to certain carried interests — known as "profits interests" in the tax world — as ordinary income that is subject to employment taxes as opposed to capital gain.

Although this change seems to be targeted at private equity fund managers, it would have an enormous effect on real estate developers, sponsors, managers and entrepreneurs.

The most difficult aspect for my practice is the uncertainty of whether and when a change in law would be effective. The various congressional proposals have not grandfathered existing ventures, and for both those existing deals and new ones that are being formed now, clients have difficult structural choices to make as they attempt to handicap the odds and timing of legislation.

Q: Outside your own firm, name an attorney in your field who has impressed you and explain why.

A: Fred Klein at DLA Piper. Fred is one of the deans of the real estate bar in the D.C. area, with a sterling reputation as an excellent lawyer.

Nevertheless, Fred has always been a joy to work with, as co-counsel and across the table, even when I was young and inexperienced. He treats everyone with respect, keeps his sense of humor and focuses on important issues.

Although I have some good role models in my own firm, I also aspire to be more like Fred.

Q: What is a mistake you made early in your career and what did you learn from it?

A: I was at a negotiation retreat for a large merger and acquisition transaction, attending a breakout session with the in-house tax professionals and the tax lawyers from both sides.

I talked too much and took some of the issues too seriously, with the result that I steadily became more agitated and combative. Luckily, my client was an experienced negotiator and lawyer himself, and he took me aside and calmed me down.

I try to remember that experience when I find myself talking too much or losing control of emotions in negotiations.