Summer 2011

Perspectives on Real Estate

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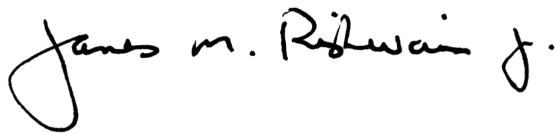
Pillsbury Winthrop Shaw Pittman LLP

From the Chair

Welcome to the Summer 2011 edition of Pillsbury's *Perspectives on Real Estate*. We decided to focus this edition on public-private partnerships (PPPs) because so many of our clients are involved in these ventures. Typically, PPPs are partnerships between a governmental entity and one or more private parties, specially created to design, build, operate and maintain public projects—such as roads, power plants, hospitals or schools—or some combination of these activities. PPPs also may be viewed in a broader context, to include such things as affordable housing projects (where tax credits make the projects economically feasible) or urban infill projects made possible because of tax increment financing and other financial support from local redevelopment agencies.

True PPPs—used for many years in other countries—are becoming more popular in the United States. In the current economy, as governmental entities look for creative and cost-effective ways to get necessary projects built, partnering with private developers is one way to help public agencies achieve these goals. Likewise, developers are looking for non-traditional sources of capital to fund development and for the constant income stream generated from providing services for public entities.

PPPs present a full array of business and legal issues that go well beyond traditional real estate matters, such as entity formation, financing, tax, environmental (state and federal) and construction contracting. This edition of *Perspectives on Real Estate* touches on several of these areas, with articles that include: a Q&A with Edgemoor Real Estate Services (an affiliate of Clark Construction Group, LLC), relating to its extensive experience with PPPs; a general overview of PPPs and a case study from ARUP; the role tax credits (low-income housing tax credits and new market tax credits) can play in bringing services and affordable housing to communities; and a description of risks and strategic opportunities regarding compliance with federal environmental laws for federal projects. I hope you find these articles as useful and informative as I have.



Jim Rishwain
Firm Chair

Bringing Entrepreneurship to Public Projects:

An Interview with Edgemoor Real Estate Services

by Glenn Q. Snyder

I recently had a conversation with Edgemoor's Neal Fleming to get his views on the state of public-private partnerships (PPP) in the U.S. and the lessons Edgemoor has learned in its own PPP projects. Mr. Fleming is a Principal of Edgemoor and provides executive leadership for all of Edgemoor's pursuits. With more than 35 years of experience in construction and real estate development, he began his career at The George Hyman Construction Company and was a founding member of OMNI Construction, which later merged to form The Clark Construction Group, Inc .

Until recently, a government agency in the United States that wanted to build public infrastructure—for example, a university building, courthouse or road—had only one project-delivery choice. Federal, state and local public contracting laws mandated a slow, cumbersome and often arcane process involving innumerable detailed steps and rigid requirements for each step. This traditional "design-bid-build" process required the agency first to complete its design and engineering (often involving a separate process of RFPs, bidding and award approval) to a degree of completion adequate to allow competing contractors to bid on fixed-price construction contracts (again pursuant to a lengthy process of RFPs, bidding and award approval).

Not only has this process led to inefficiency, delays and high costs, it also is not uncommon for public facilities to suffer from deferred maintenance and substandard operating performance due to reduced appropriations.

In recent years, the Federal government and many states have enacted statutes that, to varying degrees, allow departures from the traditional design-bid-build process and allow public agencies to utilize the more collaborative and streamlined "design-build" approach, where a single private entity provides unified design, engineering and construction services, and, in some cases, also provides financing for the project and/or facility maintenance and operation services through a long-term lease.

This movement toward government collaboration with the private sector in delivering and operating public facilities has given rise to the "public-private partnership" (often referred to as PPP or P3) phenomenon. One private company that has been at the leading edge of the PPP wave in developing government buildings and other public infrastructure is Pillsbury client Edgemoor Real Estate Services, an affiliate of Clark Construction Group, LLC, of Bethesda, Maryland. Pillsbury worked with Edgemoor on two PPPs recently: the University of California-San Francisco Neurosciences Building and the Governor George Deukmejian Courthouse in Long Beach, CA.

Defining PPP and the Risk Spectrum

SNYDER: Neal, thanks for making time to join me. From your point of view, what is a "public-private partnership"?

FLEMING: Many people say the term "public-private partnership" only applies to performance-based or availability-based infrastructure projects, following the Canadian model. However, I disagree. A public-private partnership exists any time the public sector and the private sector join in a collaborative effort to get a project done outside the usual

design-bid-build process. So I would call a government design-build project in its finest form a kind of public-private partnership because, obviously, a design-build project has to be very collaborative and the government body has to place a lot of trust in you.

SNYDER: Don't PPPs require the private party to invest or have attributes of ownership, even if it's just taking some of the risks that usually go with ownership?

FLEMING: While some PPP structures have private financing or ownership of the asset, it is not a requirement. Private investment is only one aspect of PPP, and, more often than not, the best solution does not include private financing. Regarding risk, frequently the public entity goes after a PPP thinking it will shift all of the risk to the private sector, but that rarely ends up happening. There are varying levels of risk that the private partner can take on. First, you have design-build, which is at the low end of risk for the private side. The next would be design-build-operate with government financing, where the private party develops the project and operates it for a term, but the project is ultimately financed with a public financing structure. The UCSF project falls into this category. We analyzed multiple structures—including private financing—but determined in the end that public financing through a non-profit entity was the most cost-effective solution for our client. Frequently, the public entities start out thinking the deals will use private financing, but, when you start analyzing the numbers, it's hard to beat tax-exempt financing. The notion that the private party comes with the money is not always the case; it comes with tons of risk—risk of delivery, risk of performance—but not necessarily the financing risk.

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The Long Beach courthouse deal was a design-build-operate-private finance deal, the next type on the risk spectrum. That deal was a "performance-based" or "availability-based" lease, as in the Canadian model. The private party guarantees not only on-time delivery of the project at a fixed price, but guarantees the project's availability and performance to agreed standards over the term of the lease. If the project is late, the private party pays a penalty, and, if certain performance criteria aren't met, the rent is partially or wholly withheld. This model is the riskiest form of PPP for the private party and the least risky for the public side.

There are other structures you could call "public-private partnerships," including complete privatization of a government facility or long-term leases of government property for non-governmental use. But the three main categories are design-build, design-build-operate-government finance, and design-build-operate-private finance.

Benefits to the Public Agency

SNYDER: Why do government agencies want to do public-private partnerships? What's in it for them?

FLEMING: What we hear over and over again is, number one, it allows them to fix their costs early, and that is clearly a benefit. The bidders on a design-build project have the conceptual plans and some degree of specifications, and they bid on the design, engineering and construction of the project up front. So the public agency can lock in its costs many months, maybe years, before it could have under the old design-bid-build scenario.

Another benefit is having a single point of responsibility: if you have one private entity designing, building and operating the facility, there's no finger-pointing. And then there's the Long Beach courthouse rationale: that agencies often have difficulty maintaining capital assets over the long-term, but in a performance-based social infrastructure deal,

such as the courthouse, the private sector is incentivized to maintain that building 30 years from now with the same degree of quality it has on the day it delivers it.

As budgets are cut, the first thing that's cut is maintenance budgets on buildings, roads, etc. So one of their motivations is to lock in a high level of maintenance over the term of the lease. That assures they get a far better building over the life of the lease than if they were to maintain it themselves. And that includes capital equipment replacement and capital expenditures, whether it's a new roof, new chillers, all of that is included in the pricing on the Long Beach courthouse deal.

Time and cost go hand in hand, so they're very motivated to overlap activities at the private sector's risk to ensure that things are done timely.

One other big benefit of public-private partnerships: time. You know, if you do things in the traditional way that governments procure things, first it's land acquisition and then it's program development, then you put out a solicitation for architects and you get those in, and you pick an architect, and you do design, and after the design is complete you get the permits, and after the permits are complete you solicit for a contractor. It's all very linear. And it's so linear that it can take three years from concept to completion of design and solicitation of proposal, whereas we're doing it in six months. In six months, we're basically doing a preliminary design and we're taking the risk for everything else and on all the other steps we're going to overlap. Time and cost go hand in hand, so they're very motivated to overlap activities at the private sector's risk to ensure that things are done timely.

Assessing the Likelihood of Success of a PPP

SNYDER: What do you look for when you evaluate a potential public-private partnership?

FLEMING: Everybody wants to look at this as a magic pill—public-private partnerships can make something happen that otherwise government couldn't do. And so we see a lot of solicitations that agencies put out there that aren't going anywhere, but people are going to spend a lot of money and time on them. So the criterion we look at, first and foremost, is does the procuring agency have legal authority to do a public-private partnership. There are instances where states have put out solicitations for public-private partnerships, and, after firms spend a lot of money responding to them, the procuring agency says, "you know, we really haven't passed the legislation yet."

The second thing we look at is, regardless of how important somebody says the project is to them, is there a strong market need for that facility? Whether it's a jail, a courthouse, a university building—is there truly a strong market need? If there is no strong market need we think that there's a better than 50-50 chance of the project being delayed or abandoned. The third key criterion—is there a passionate political champion pushing this thing forward? The UCSF project could have died because its passionate political champion retired. Then the leadership of the new chancellor combined with the passion of a lot of important scientists pushed the deal forward. You want to have the governor support it, you want to have the legislature support it, you want to have all those things, but really there has to be one key person that says, "I'm going to make sure this is going to happen."

Performance-Based Infrastructure

SNYDER: Do you think the "Canadian model" of performance-based infrastructure projects is catching on in the U.S.?

FLEMING: In a traditional U.S. lease, you rent your space and if the electricity goes out, or if the space is not cleaned, it doesn't matter. You still pay rent. You write a letter that you're angry, but you still have to pay rent. In an availability lease, which is this PPP model out of Canada, once the building is complete and the private party is operating it,

An Interview with Edgemoor Real Estate Services (continued)

if there's a performance problem—if the temperature isn't within two degrees of what it's supposed to be, if there's graffiti on the bathroom walls, if the security system malfunctions, there's a whole long list of things—if any of those occur, they don't pay rent or the rent is reduced.

SNYDER: In the U.S., where lenders are used to leases with no right to abate rent, that kind of deal would be tough to finance.

FLEMING: That is the main issue. U.S. banks, when they look at financing a lease deal, they say, "Well, it's hell or high water and you've got to pay rent." If I'm a European bank—and there were five or six of them on the Long Beach deal—they looked at us and said, "Look, the risks in this deal of the design-builder not performing, those have to go to the design-builder, and the design-builder has to have enough skin in the game to guarantee performance or pay penalties, liquidated damages." When we get the building up and operating, they look to the operator to have enough skin in the game to guarantee performance, and the operator has a contract that says if any of those events occur, they will be responsible for loss of rent. So the lenders get to a hell-or-high-water level of comfort by a combination of factors; it's not just the government lease, but it's the financial strength of the design-builder and of the operator. Ultimately I think that everybody will figure out a way to do it, but right now it's just so different from how they've financed deals in the past that the financing for performance-based deals is coming from European banks right now.

Our observation is, "Once you've done one public-private partnership, you've done one."

Our observation is, "Once you've done one public-private partnership, you've done one." Each one is unique as to what the particular state or municipality allows and what the particular public client is looking for. There's no single formula. In Canada, they put together an infrastructure trust fund on a national basis, and, in order to get funds from that fund, a provincial or local government body has to adhere to uniform contract guidelines. And so, as a result, as different provinces wanted to borrow money from this national infrastructure trust fund to build hospitals or prisons or courthouses, they had to adhere to the same contract standards. That makes things more predictable for everybody in the process. They know what to expect and how the risks are allocated.

So now, government agencies in the U.S. say this is an attractive model. It's well thought out, and it includes the guaranteed maintenance, and it includes the availability payment concept, so that, if the building isn't properly maintained, they pay less rent. So let's bring it to the United States. But here, of course, every state, every local government, every county—they all function differently, they all have their own particular rules. For instance, on UCSF, we were basically writing a contract from scratch for the first time; there was no model for them to follow, no model for us to follow, no document you could pull off the shelf. It's extremely complicated, I would say, to put these deals together, because there isn't a model contract. Whether it's Texas or Pennsylvania or Florida, everybody's going to want to do it "their way." And that means that every deal, in my opinion, is very different, very unique. I think it's important for people to know that public-private partnerships, although you can have a goal in mind and a general form of where you want to go, a deal will evolve to suit that particular entity's needs and wants and how much risk it wants to share and how much control it wants to have. And so I push back when people tell me that the wave of public-private partnerships is going to look exactly like the Canadian model.

Lessons Learned and Secrets to Success

SNYDER: So, based on your experience with public-private partnerships, what are the key lessons for private companies that want to succeed in that arena?

An Interview with Edgemoor Real Estate Services (continued)

FLEMING: Having firms that have done it before as your consultants. That would be high on my list, both on the public and private side. This is not an arena where you can figure it out on the fly, unless you want to incur huge legal costs on both sides of the fence. So it's important to use people that have done it before, that can bring some history and some direction to the process and can help identify the risks and really think them through.

You also need to allocate risks appropriately between the public side and the private side. No matter what risk you ask a private party to take, they're going to include it in their price—this is the tradeoff. I think that the party that's best able to control the risk should take the risk. So if it's about entitlements or zoning or possibly even utilities, I think governmental agencies are better suited, in a better position, to take those kinds of risks because they can manage them. And if it is a construction-related risk, the design-builder is in a better position to take that risk. When the government agency says "I don't want to take any risks at all," they're going to find that the private sector will price it accordingly and that's not necessarily in anybody's best interest.

Finally, one of the most important things the private sector can bring to public projects is creative ideas and problem-solving. For instance, on the Route 28 limited access freeway PPP project near Dulles Airport, the local landowners had decided to form a district to tax themselves to pay for road improvements to increase the value of their land. After the initial road construction, the landowners planned to build ten additional interchanges over a 20-year period with the Commonwealth of Virginia paying 25% and the landowners paying 75% of the cost. We recognized that the income stream from the taxes could be monetized and submitted a PPP proposal to undertake this scope of work. Our proposal allowed the construction of the interchanges to occur at today's costs, and we made all improvements to the corridor in less than 10 years. The landowners' land values increased, and they were able to attract office tenants and hotels and all the other development they had envisioned sooner rather than later. This entrepreneurial approach created a win-win situation for the Commonwealth, local government, private landowners and the traveling public.

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Social Infrastructure Public-Private Partnerships—Helping Governments Overcome Budget Constraints to Deliver Public Services

With a Project Spotlight on ARUP and the Long Beach Courthouse

by Ignacio Barandiaran

Federal, state, and local governments increasingly are using public-private partnerships (PPPs) to facilitate the construction of major infrastructure projects. Such PPP projects include toll roads, bridges, mass transit, ports and other large-scale projects. Across the United States, state and local governments are grappling with fiscal difficulties as a result of the combined effect of the economic downturn and longer-term structural budget pressures from rising pension and healthcare commitments. These fiscal difficulties are affecting the largest of state economies, as well as the smallest of municipalities' budgets.

Amidst these difficulties, governments are trying to identify ways to fund their *essential* social infrastructure—schools, libraries, courthouses, public healthcare facilities, parks, roads, water and sewer systems—that enable their communities to thrive. This challenge is compounded by governments' reduced expectations of resources being available and allocated to fund their social infrastructure on a sustainable basis, now and for the foreseeable future.

Image courtesy of Clark Design/Build of California, Inc. & AECOM Services, Inc.

Social Infrastructure

Governmental entities partnering with private enterprises in order to deliver public facilities and infrastructure is not a new phenomenon. However, until recently, U.S. governments have not embraced the use of long-term public-private partnerships as a means to finance, construct and operate social infrastructure projects, although PPPs are commonly used in other countries.

In the U.S., federal agencies, including the General Services Administration, the Department of Veterans Affairs and the Department of Defense, have experience in partnering with private enterprises to deliver facilities, such as government offices, court buildings, public healthcare facilities, prisons, military housing and other major projects, through a variety of procurement approaches and deal structures. State and local tiers of governments, including states, counties and cities, also have used similar procurement approaches for the delivery of their social infrastructure, such as schools, college campuses and public sports/recreational facilities.

Although broadly termed "public-private partnerships," these experiences for the most part have not included the use of long-term public-private partnerships as commonly used in other countries, such as Canada, Europe and Australia. In these countries, the terms "P3" or "PPP" have a more narrowly defined meaning.

In this context, PPPs have the following fundamental characteristics:

Social Infrastructure Public-Private Partnerships—Helping Governments Overcome Budget Constraints to Deliver Public Services (continued)

- The use of long-term contracts for the delivery of services by a private partner that include design, construction, operations and maintenance, using project finance techniques.
- The retention of ownership and ultimate control of the asset by the public partner whereby it retains only those risks that it is best positioned to manage, such as land acquisition and force majeure events.
- The making of performance-linked payments by the public partner to the private partner in exchange for the services delivered by the private partner.
- The acceptance of the risks and opportunities associated with cost, schedule and level of service performance that are transferred to the private sector by the providers of the private capital used to finance these PPPs.

Properly structured and executed PPPs are a tool that state and local governments can use to finance, construct and operate their infrastructure projects. The benefits of these PPPs for the public sector include:

- A more cost-effective delivery, by transferring most construction cost and schedule risks to the private partner, who is best positioned to manage those risks and who can optimize design with life-cycle maintenance costs.
- Dedicated funding for the PPP project that is not subject to short-term, political decision-making or diversion of funding to other non-essential assets, which in turn results in:
  - A higher level of service for the users during operations; and
  - Adequate funding and management to prevent premature deterioration and cost overruns for replacement and refurbishment.
- An additional financing and procurement option that can be supplementary to traditional pay-as-you-go and municipal financing methods.

Project Spotlight: ARUP and the Long Beach Courthouse

ARUP has an extensive history of planning, designing and engineering complex PPP infrastructure and building projects and in structuring, analyzing and leading through procurement PPP deal structures for these projects. The firm's project experience ranges from providing financial and technical advice to the local transportation agency delivering California's Presidio Parkway PPP project to supporting the developer of a large PPP sports and entertainment complex in Singapore. A recent PPP project success story is the Long Beach Courthouse in the City of Long Beach, California, in which ARUP advised the equity and debt investors.

About the Project

Built in 1959, the existing Long Beach courthouse is a functionally deficient facility that suffers from overcrowding, failing internal systems, structural problems and obsolete security systems. The Long Beach courthouse is the busiest in the California judicial system and one of the busiest in the United States, averaging 109,000 visitors, 385 felony filings and 3,300 misdemeanor filings per month.

The new Long Beach courthouse building will be approximately 500,000 square feet, and it will house 31 courtrooms. The courts will occupy roughly three-fourths of the overall space, and the rest of the space will be used for offices of county justice agencies and for commercial office and retail space that is compatible with courthouse uses.

The Long Beach courthouse project represents the first project in California, and possibly in the U.S., for which a local court system will use a long-term, project financed PPP delivery arrangement. This arrangement leverages the private sector's access to financing, technological expertise, management efficiency and a financially incentivized

Social Infrastructure Public-Private Partnerships—Helping Governments Overcome Budget Constraints to Deliver Public Services (continued)

business approach to provide a high-quality facility that will serve the needs of the Superior Court of Los Angeles County and enhance the public's access to the justice system.

Key Aspects of the Transaction

This project, which reached financial close in December 2010, is the first social infrastructure PPP project in California to employ the traditional means of PPP procurement as described above and frequently used in other countries.

For this PPP project, the basic deal structure is as follows:

> *This arrangement leverages the private sector's access to financing, technological expertise, management efficiency and a financially incentivized business approach.*

A consortium of private partners, referred to as the "private-sector consortium," will design, build and then maintain the facility for 35 years. To finance the initial development costs, design and construction, the private sector consortium at financial close put in place a project-financing package consisting of long-term equity (10%) and debt (90%), with a total investment of just under $500 million. In exchange for these services, the private-sector consortium will be paid an annual service fee by California's Administrative Office of the Courts (AOC), which owns the land and the building, with such payments starting only upon completion of construction to the AOC's satisfaction. The service fee was contractually fixed at the time of financial close and has a mortgage-like payment profile over the 35-year operations period, plus an inflation indexation. At the end of that 35-year period, the private-sector consortium will hand back the facility to the AOC in good physical condition, as specified in the PPP long-term contract.

The service fee payments are linked to specific availability and performance milestones, which involve specified response times and potential payment deductions if requirements are not met. The most important milestone is the availability of fully functioning courtrooms for their intended use each day of the year. There also are a range of other maintenance and operational performance indicators, such as measurable targets for energy efficiency, which, if not met, may trigger deductions in the service fee payments.

This arrangement gives the private sector a great incentive to complete the construction of the project on time and on budget, so that the service fee payments start as scheduled, and then to operate and maintain the project in good condition to avoid potential deductions in payment.

The Long Beach PPP Team

This private-sector consortium is led by Meridiam Infrastructure (Meridiam), a New York-based firm that has built a business focused on investment in public–private infrastructure projects and has a team of professionals from across the world with extensive experience in PPP investment, engineering, industrial strategy, asset management and financial sector services. Meridiam also is the equity investor in the deal.

The private-sector consortium in turn is contracting for the design and construction of the courthouse with a team led by Edgemoor Real Estate Services, an affiliate of Clark Construction Group, LLC, and for the facilities maintenance with a team led by Johnson Controls.

A syndicate of six banks with extensive project finance experience provided the debt package to complete the financing.

Social Infrastructure Public-Private Partnerships—Helping Governments Overcome Budget Constraints to Deliver Public Services (continued)

ARUP's Role

A PPP procurement contains private sector risks within the project finance structure, with the only source of repayment being the project cash-flow that is contingent upon delivery of a properly constructed and maintained facility. The security is the 35-year PPP contract, there being no ownership interest in the land or the building. Therefore, both the equity and debt investors have an overriding need to identify risks up front, and then to manage, mitigate or transfer them.

As such, PPP procurement requires experienced investors and advisors that are familiar with the contractual requirements, the project's technical and commercial fundamentals and the financial structure used to address these issues.

Furthermore, the current challenging economic environment has amplified the need to conduct a rigorous analysis of the financial and delivery risks associated with any PPP project. To fill this critical role in the LB courthouse project, Meridiam appointed ARUP as the Lender's Technical Advisor (LTA).

ARUP's role as LTA was to identify and evaluate project risks, their allocation, and mitigation strategies from a technical and commercial perspective.

A First for California, but Not the Last

"This is a first in the state of California for a project of this magnitude," said Long Beach Mayor Bob Foster in an announcement published by the city. "Long Beach has found a unique and creative way to maximize our local dollars and enter into a public-private partnership that will result in a new courthouse for our city."

With a PPP procurement for this large and complex project, California's AOC is achieving a series of important benefits that can provide a model for other state and local agencies around the country, including:

- **Earlier completion**—the AOC estimates that the project will be completed 30 months earlier than a traditional segregated procurement.
- **Lower cost**—as a direct benefit of earlier completion, the construction bid was more than 15% below AOC's estimates.
- **Integrated procurement**—ensures that the design and maintenance proposals are optimized with each other, therefore reducing life-cycle costs.
- **Fully funded maintenance**—because all payments to the consortium are the AOC's contractual obligation and they are directly linked to potential performance deductions, occupants and visitors to the courthouse will enjoy a well-maintained and high-quality building for the next 35 years.

Although the LB courthouse project is California's first PPP social infrastructure project, the state's needs for ongoing investment and more cost-effective delivery of its essential social infrastructure nearly assures that this will not be California's last. Indeed, the project's success is a new template for governments throughout the state and possibly the country into using PPPs for social infrastructure.

Pillsbury and ARUP have worked as co-advisors for infrastructure clients on legal, engineering and business aspects of their complex projects. Ignacio Barandiaran is a Principal with ARUP, an international and independent firm of project finance advisors, transaction specialists, planners, and engineers offering a broad range of professional services. He is based in San Francisco and can be reached at 415.946.0202 or ignacio.barandiaran@arup.com.

The Federal Low-Income Housing Tax Credit Program: 25 Years of Public-Private Partnerships

by Kimberly C. Moore

One of the best examples of a strategic partnership between the public and private sectors is the federal Low-Income Housing Tax Credit Program (LIHTC Program). Created as a part of the Tax Reform Act of 1986, the program has developed over the last 25 years into a highly efficient collaboration among a diverse set of participants, including for-profit developers, nonprofit organizations, institutional investors, and federal, state and local governmental agencies.

The LIHTC Program has been the primary source of low-cost capital in the United States for the development and preservation of affordable rental housing, and is arguably the nation's most successful affordable housing program. According to the National Council of State Housing Agencies, since its inception the program has created more than 2.4 million low-income affordable housing units.

How the LIHTC Program Works

The success of the program is due in large part to combining the discipline and efficiencies of the private sector with the benefits of the oversight and regulation of the public sector. The federal government allocates LIHTC Program credits annually to each state based on population. Following a public notice and comment period, state agencies develop qualified allocation plans, which reflect the particular state's affordable housing priorities, and award their tax credits to projects that are representative of such priorities. State and local governmental agencies also participate in the program by providing loans or other financial assistance to projects.

The LIHTC Program then provides financial incentives for private investment in the affordable rental housing projects. Developers apply for the tax credits in a competitive process, and, if selected, they can earn development fees for constructing or rehabilitating qualified low-income housing projects, property management fees for managing projects in compliance with LIHTC rules and additional incentive fees for the efficient operation and management of projects. Qualified nonprofit developers also are eligible to receive a right of first refusal to purchase the project at the end of a 15-year compliance period at a statutorily prescribed below-market purchase price.

A Market Competing for Credits

Institutional investors, including national and regional banks, insurance companies and other corporations "compete" for participation by virtue of the price they are willing to pay for the LIHTC Program credits. In exchange for a capital investment, investors receive dollar-for-dollar tax credits over a 10-year period.

Because an investor's ability to claim the tax credits is dependent in large part on the successful construction (or rehabilitation), lease-up, operation and ongoing compliance with the technical requirements of the LIHTC Program, investors bring efficiencies to the program through their participation in the initial underwriting and ongoing

The Federal Low-Income Housing Tax Credit Program: 25 Years of Public-Private Partnerships (continued)

oversight of project investments. Private-sector participants must complete construction or rehabilitation of the project and lease units at affordable rents to tenants who meet specified low-income levels before such participants are eligible for the LIHTC Program credits.

Economic Conditions Spur New Programs

Amid tightening public budgets and weak economic conditions, the LIHTC Program also mirrors the weakness of both the public and private sectors. But where public housing funds have dried up, the private sector has found new and creative solutions, and where the private sector's participation in the program has faltered, the public sector has stepped in.

This interplay of public and private sector efforts was demonstrated most visibly during the recent financial crisis, when a decline in investor profitability resulted in a sharp decline in LIHTC investments from nearly $9 billion in 2006 to half that level in 2009. To encourage continued investment in affordable housing through the LIHTC Program, Congress created two new programs as a part of the American Recovery and Reinvestment Act of 2009: the Tax Credit Assistance Program, which provided gap funding from the U.S. Department of Housing and Urban Development to otherwise stalled LIHTC Program projects; and the Section 1602 Tax Credit Exchange Program, which allowed states to exchange a portion of their LIHTC Program credits for grant funds from the U.S. Department of the Treasury to finance affordable housing projects.

Private-sector coalitions and organizations, including both profit-seeking participants and mission-oriented not-for-profit groups, are instrumental in shaping legislative housing policy and dialogue, while public-sector legislation and policy provides an effective means of correcting market imbalances.

Together, these partnerships of public and private-sector participants have resulted in a more efficient use of federal, state and local resources and have created the largest number of affordable rental housing units in U.S. history.

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Minimizing the Impact of the National Environmental Policy Act on Public-Private Ventures

by William A. Wilcox, Jr. and Jeffrey A. Knight

The National Environmental Policy Act (NEPA) is the primary environmental planning law for projects implemented or approved by the federal government and for projects receiving federal funding. The primary objectives of NEPA are to require federal decisionmakers to consider environmental impacts before resources are irretrievably committed to a project and to give the public an opportunity to shape the project's design and implementation.

Soon after NEPA's passage, the U.S. Supreme Court recognized that NEPA created a private right of action for affected parties to enforce NEPA's planning requirements through the federal court system. As a result, opponents frequently use NEPA litigation as a tool to influence, slow and sometimes defeat federal projects. In projects involving public-private ventures (PPV) with federal agencies, private parties with an interest in the PPV or in the PPV project should be cognizant of both the strategic opportunities in the NEPA planning process and the risks that can be created if the federal agency fails to satisfy all NEPA environmental planning requirements.

PPV projects also may be subject to state and local environmental review processes, such as the California Environmental Quality Act (CEQA) and the New York State Environmental Quality Review Act (SEQRA). For the most part, state and local environmental reviews can be performed concurrently with a NEPA review using the same or similar documentation. However, unlike NEPA, some "mini-NEPA" laws impose substantive obligations on state agencies to reduce or avoid environmental impacts.

NEPA Fundamentals

The central mandate under NEPA requires the lead federal agency for any major federal action significantly affecting the quality of the human environment to prepare a detailed statement of:

1. the environmental impact of the proposed action;
2. any adverse environmental effects that cannot be avoided should the proposed action be implemented;
3. appropriate alternatives to the proposed action;
4. the relationship between local short-term uses of the environment and the maintenance and enhancement of long-term productivity; and
5. any irreversible and irretrievable commitments of resources that would be involved in the proposed action should it be implemented.

Minimizing the Impact of the National Environmental Policy Act on Public-Private Ventures (continued)

NEPA-implementing regulations developed by the White House Council on Environmental Quality (CEQ) established rules for conducting the type of environmental analysis required for a given activity or project. Most federal agencies have expanded on the CEQ regulations by adopting their own agency- and action-specific NEPA regulations. It is not always obvious early in the planning process whether a project is a "major federal action" triggering NEPA review. For example, a federal agency action that only indirectly affects the environment, such as a decision to provide funding or a licensing decision, may trigger NEPA review. For PPV projects, an agency decision to commit federal land or federal funds for development typically constitutes a major federal action sufficient to trigger NEPA. Therefore, involvement by NEPA specialists at the project definition stage can be critical to identifying possible NEPA triggers and making adjustments to streamline the level of NEPA review required for a project.

Involvement by NEPA specialists at the project definition stage can be critical to identifying possible NEPA triggers and making adjustments to streamline the level of NEPA review required for a project.

An agency must prepare different types of NEPA documentation depending on the nature of the project and the level of potential environmental impact. If an action or project will not have an adverse impact on the environment, or any impact will be minimal, NEPA documentation is still required. Most federal agencies have adopted in their NEPA implementing regulations a number of "categorical exclusions" (often referred to as "CATEXs" or "CATXs") for which only very minimal NEPA review is required. Categorical exclusions consist of modest or routine actions, such as standard maintenance and repair in the ordinary course that the agencies have determined presumptively do not pose significant impacts to the environment individually or when considered together with other projects. The use of categorical exclusions is encouraged by the CEQ regulations. There is no public notice requirement for a project that is covered by a categorical exclusion, so this form of environmental review generally does not add significant time or cost to the project planning phase.

The next level of NEPA documentation is the Environmental Assessment (EA). An EA is appropriate if a project is not covered by one or more categorical exclusions and it is likely that a full Environmental Impact Statement (EIS) is not necessary. An EA generally is created to evaluate whether the environmental impacts of the activity or project may be significant and, thus, require more extensive review through an EIS. An EA must be advertised to the public and made available for review and comment. The period of review varies among the agencies, but normally it will not be shorter than two weeks. The EA can help the lead agency determine whether to prepare a more exhaustive EIS, but an EA is not a prerequisite to an EIS. If an EA is completed and it results in a "finding of no significant impact" (often referred to as a "FONSI"), then the NEPA review for the project is complete. For most projects, approximately six to 12 months should be allotted to prepare and finalize an EA/FONSI.

If, however, the EA reveals that the action would cause significant environmental impacts, then an agency often seeks to add mitigation measures to the project or to change the project scope or design in ways that reduce impacts to less-than-significant levels. If impacts cannot be reduced to less-than-significant levels, the agency must prepare an EIS. Agencies also sometimes choose to prepare an EA or an EIS for strategic reasons even when less analysis is required by law, for example, if the agency desires changes to a project scope or design or if the agency seeks to build public support for a proposed action. Preparing an EIS involves more extensive planning, information collection, analysis and public involvement. When the final EIS is adopted, the lead agency issues a Record of Decision (ROD) documenting which project alternative has been selected and describing any mitigation measures the agency will implement. Preparing an EIS and ROD generally takes 18-24 months, although the EIS process for very complex or highly controversial projects may take several years to complete.

Minimizing the Impact of the National Environmental Policy Act on Public-Private Ventures (continued)

NEPA Strategies

It is in a PPV's best interest to ensure that its partner federal agency complies with the requirements of NEPA so that a project is not imperiled or delayed by lack of planning or by lawsuits challenging the agency's NEPA compliance. While the federal agency is ultimately responsible for NEPA compliance, many agencies permit—and some require—the project proponent (e.g., the PPV) to perform the data collection and prepare drafts of the NEPA planning documents. This approach can be very desirable for PPV projects where the federal agency may not have the NEPA planning resources or motivation to prepare an EA/EIS on a schedule suited to the PPV's business planning. When partnering with agencies who prepare their own NEPA documents, PPVs should review and provide input early on to help ensure compliance with CEQ's and the agency's NEPA regulations.

Agencies are required to initiate the NEPA review early in the project planning process and to comply fully with all NEPA requirements before committing to a specific project alternative. This requirement is strictly enforced by courts. An agency is vulnerable to litigation if it takes action on a project that will limit the choice of reasonable alternatives and merely uses an EA or EIS to justify that action after the fact. Thus, any action on a project that would predispose a federal agency toward a particular decision outcome, such as awarding a contract to begin site preparation work, makes the action vulnerable to legal challenge. PPVs should communicate with federal agency partners to try to ensure that such deficiencies in the process do not occur.

Even ideal planning cannot overcome poor execution of the NEPA documentation.

Another issue that arises in NEPA practice is determining when projects that are related to one another (e.g., multiple phases of development by the same PPV) may properly be reviewed separately. Preparing separate NEPA documentation can be desirable because it may allow an immediate project to be reviewed and approved without the delay of studying the potential impacts of a future, more speculative project. However, CEQ's regulations and court precedent prohibit the practice of dividing a single action for separate NEPA review (referred to as "segmentation" or "piecemealing") if each action does not have independent utility. Such segmentation is prohibited because agencies could avoid preparing EAs and EISs and fully disclosing impacts by fragmenting a single project into multiple actions, each with less-than-significant environmental effects. Segmentation may occur, for example, where an agency prepares separate NEPA analyses for two segments of a highway that have logical starting and stopping points only when considered together as a single project.

Documentation Matters

Finally, even ideal planning cannot overcome poor execution of the NEPA documentation. The more robust and better supported the analysis of alternatives and impacts, the more likely that an EA or EIS will be accepted by the lead agency and withstand judicial review. Under prevailing case law, agencies must give serious weight to environmental factors when making project decisions. In doing so, federal agencies must apply a rule of reason to determine what factors to analyze in the EA or EIS. While mere speculation or worst-case analysis of potential impacts is not required, vague or incomplete analysis often generates greater agency and public scrutiny and creates opportunities for opponents to raise legal challenges. PPVs should assist federal agency partners to ensure that the appropriate level of analysis is prepared and that it incorporates all of the available project information.

In addition to minimizing litigation risk, close PPV participation in the NEPA process helps to ensure that the scope and schedule of the proposed project is not adversely altered in the environmental planning process. When federal agencies consider environmental impacts of proposed projects—particularly major development projects—agencies often look to incorporate measures to mitigate potential environmental impacts associated with building and

operating the project. This common practice can lead to a prudent balancing of environmental stewardship with the overall purpose and need for the PPV project. PPVs, however, should be actively involved in the mitigation development stage so that agencies do not propose unnecessary or onerous mitigation measures that impact the project.

Conclusion

Early planning and coordination is essential in order to make use of opportunities to streamline and expedite the NEPA review process for PPV projects while ensuring adequate protections against legal challenges. When the fortunes of a project are intertwined with the outcome of federal planning, PPVs have a strong strategic interest to participate closely in the NEPA review to ensure that the process ultimately benefits the proposed project.

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Keeping the Government Accountable: Enforcing Contracts With "Non-Appropriated Fund Instrumentalities" Is Now Easier

by Daniel S. Herzfeld

In January, the U.S. Court of Appeals for the Federal Circuit ruled in *Slattery v. United States* that non-appropriated fund instrumentalities of the U.S. government (NAFIs) are not immune from lawsuits at the U.S. Court of Federal Claims, unless Congress expressly withholds or withdraws jurisdiction. Assuming the Supreme Court does not overrule the decision, private parties now have a more predictable path to enforce contracts with NAFIs.

NAFIs are government-sponsored or government-controlled entities that do not receive regular appropriated funds, and are a vehicle by which the federal government contracts with private vendors, including as part of public-private partnerships. The military exchanges, such as the Army and Air Force Exchange Service, are the most prominent, and occasionally serve as the "public" contracting party in public-private military housing deals. The Army's Morale, Welfare and Recreation NAFIs, for example, allow public-private ventures for, among other things, aquatic centers, bowling alleys and recreational lodging in cabins, cottages, hotels or motels on base. *See* Army Regulation 215-1, § 15-12.

Dilemmas Created by the NAFI Doctrine

About 60 years ago, the federal courts adopted the "NAFI doctrine," which established that NAFIs were immune from lawsuits—they could not be held accountable for breach. The doctrine granted to NAFIs all the immunity of the federal government, generally allowing NAFIs to avoid all contract liability resulting from their actions or inactions (with the exception of the military and NASA exchanges, which Congress made amenable to suit in 1970).

Private parties who were aware of an entity's NAFI status could, at least, plan for the possibility that they might have no ability to hold the entity accountable. However, it often was unclear both to private parties and government entities whether a particular entity was a NAFI—and not subject to suit—until a court later declared it so.

No Pizza Purchases by Marines; No Money in Suing the Mint

The immunity provided by the doctrine, together with the inability, in some cases, to forecast whether an entity was a NAFI, wreaked havoc on transactions and complicated the government contracting process. For example, in 1998, a pizza company agreement was terminated for default by a "Morale, Welfare and Recreation" NAFI established at the Marine Corps' base in Iwakuni, Japan. The contract between the NAFI and the pizza company included several clauses that appeared to make the NAFI amenable to suit. In particular, the contract stated that the NAFI's contracts

Keeping the Government Accountable: Enforcing Contracts With "Non-Appropriated Fund Instrumentalities" Is Now Easier (continued)

"are United States contracts" and incorporated the standard Disputes Clause required by the Contract Disputes Act, stating appeal or suit would be available at the Court of Federal Claims or a Board of Contract Appeals.

The pizza company appealed its termination to the Armed Services Board of Contract Appeals, which ruled against the company on the merits. The pizza company appealed further to the Federal Circuit, which never reached the merits, ruling that despite the clauses that stated the NAFI could be sued, the Morale, Welfare and Recreation NAFIs did not qualify as "exchanges" (which would have provided a basis for jurisdiction), even though they provided the same functions and operated similarly to the exchanges. Thus, the pizza company learned only after several years of litigation that it had no legal remedy to challenge the NAFI's termination of its contract. *See generally Pacrim Pizza Co. v. Pirie*, 304 F.3d 1291 (Fed. Cir. 2004).

As another example, the Federal Circuit concluded that the U.S. Mint—the federal government agency that coins the nation's money—was a NAFI, and thus entitled to rely on the doctrine. Notably, a prior decision in another case by a different trial judge had concluded that the Mint was not a NAFI. After wading into this muddle, the Federal Circuit disagreed with the prior trial decision (which was never appealed), reasoning that the Mint was run using a congressionally approved revolving fund that did not require the Mint to rely on annual appropriations from Congress. So, based on the Federal Circuit's ruling, the private contractor could not even pursue a claim for more than $1.7 million. *See AINS, Inc. v. United States*, 365 F.3d 1333, 1344 (Fed. Cir. 2004).

Demise of the Doctrine

Slattery effectively eliminates immunity for NAFIs, providing that jurisdiction at the Court of Federal Claims (and presumably at the Boards of Contract Appeals) turns not on the appropriation status of the agency's funds, but on whether the entity is acting on behalf of the government. *Slattery v. United States*, 635 F.3d 1298, 1300 (Fed. Cir. 2011) (*en banc*). The court held that "when a government agency is asserted to have breached an express or implied contract that it entered on behalf of the United States," the court has jurisdiction unless Congress explicitly withholds or withdraws jurisdiction by statute. *Id.* at 1321.

Private parties entering public-private agreements with a NAFI will still need to confirm Congress has not exempted the NAFI from court review. But now, private parties can at least demand that the NAFI provide a statute to justify its conclusion. And, because of *Slattery*, there now should be fewer circumstances where a NAFI is exempt from court review, which should make contracting with a NAFI more predictable.

This article derives from a previous article published in The Government Contractor *and appears courtesy of Thomson Reuters.*

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New Markets Tax Credits: A Growing Element in Community Development

by Josephine S. Lo and H. Carl Moultrie, III

The federal New Markets Tax Credit Program is a prime example of public-private partnerships successfully funding projects and businesses. Federal new markets tax credits (NMTCs) were created in 2000 to stimulate private investments in low-income communities and make otherwise difficult-to-develop projects feasible and viable. NMTCs have served as a source of funding for numerous types of real estate projects across the country, including schools, performance arts centers, theaters, health clinics, community and social services centers, hotels, office buildings, shopping centers, for-sale affordable housing and other nonresidential or mixed-use projects.

An investor may qualify for NMTCs by investing (directly or indirectly) cash equity in a qualified community development entity (CDE), which is typically a limited liability company that has received an NMTC allocation from the Community Development Financial Institutions Fund (CDFI Fund) of the U.S. Department of the Treasury. NMTC allocations of $29.5 billion have been made to CDEs since the inception of the New Markets Tax Credit Program, and $3.5 billion of additional NMTC allocations are expected in 2011 or early 2012.

Serving Low-Income Communities

A CDE must (i) have a primary objective of providing capital for or otherwise serving low-income communities or low-income persons, (ii) remain accountable to residents of low-income communities through their representation on the CDE's governing or advisory board, if any, and (iii) obtain certification by the CDFI Fund. A low-income community generally is a census tract with a poverty rate of at least 20% or a census tract in an area where the median income is not more than 80% of the statewide median family income. A low-income person generally is an individual whose family income is 80% or less of the area median family income.

Subject to certain requirements described below, the NMTC is equal to 39% of the equity invested in a CDE and is claimed over a seven-year period (5% in each of the first three years and 6% in each of the remaining years). All of the previously claimed NMTCs will be recaptured with interest if, during the seven-year NMTC period, the CDE ceases to qualify as a CDE, fails to invest substantially all of the equity it receives for qualified investments, or redeems such equity.

Types of Businesses a CDE Can Invest In

To qualify for the NMTC, a CDE generally must invest (either as a loan or as equity) at least 85% of the equity it receives in one or more qualified active low-income community businesses (Business Owner), commonly known as a QALICB. A Business Owner is a corporation, a partnership or proprietorship that generally conducts a "qualified

business" in a low-income community and satisfies certain income, services, property and other criteria. Because of the tax benefits, an NMTC investor typically allows a CDE to use the equity to provide a Business Owner with one or more loans that contain unconventional features, such as a below-market interest rate, lower origination fees, a longer period of interest-only payments, a higher loan-to-value ratio, a lower debt-service-coverage ratio and more flexible underwriting standards.

A "qualified business" is any trade or business other than: (i) leasing of unimproved real property or residential rental property; (ii) development or holding of intangibles for sale or lease; (iii) operation of a golf course, country club, massage parlor, hot tub or suntan facility, gambling facility or liquor store; and (iv) certain farming activity. A building is considered a "residential rental property" if 80% or more of its income is derived from the dwelling units; note that several strategies may be utilized to qualify mixed-use buildings as nonresidential rental property.

Debt Financing and Leverage Loans

Debt financing may be included as part of the equity investment for calculating the NMTC only if the borrower is the entity making the equity investment in the CDE and the financing is not secured by a mortgage or other assets of the Business Owner. Accordingly, debt financing intended to increase the NMTC ordinarily is made to an upper-tier investment fund (this type of financing is commonly called the Leverage Loan). The upper-tier fund combines the proceeds of the Leverage Loan and the capital contribution from the investor to make the equity investment in a middle-tier CDE.

Because of the tax benefits, an NMTC investor typically allows a CDE to use the equity to provide a Business Owner with one or more loans that contain unconventional features.

A governmental entity may participate in an NMTC structure in multiple roles: as an upper-tier lender of the Leverage Loan to an investment fund; as an affiliate of a middle-tier CDE formed to develop such entity's own NMTC projects; as an insurer of a CDE loan to a Business Owner; or as a lower-tier lender to a Business Owner to supplement the CDE financing. The types of funding provided by a governmental entity in an NMTC structure may include: HUD Section 108, 220, or 221(d)(4) loans; HUD CDBG or HOPE VI loans; tax-exempt bonds; brownfields funds; and city tax incremental financing.

Adjusting to NMTC Arrangements

A governmental entity making a Leverage Loan to an upper-tier investment fund will need to get comfortable with issues such as the absence of a mortgage, required entrance into an intercreditor agreement with other Leverage Loan providers, forbearance for the seven-year NMTC period, the CDE's reinvestment of equity during the seven-year NMTC period within such lender's jurisdiction, and the flow-down of statutory and regulatory requirements under the particular grant or loan program to the project level. Common issues arising from combining CDE and government financing at the lower-tier Business Owner/project level are subordination, disbursement procedures and payment priority.

More NMTCs to Come

In addition to being able to participate in an NMTC structure, at least seven states have separate state-level tax credit programs in effect that mirror or complement the federal NMTC Program, and five states have pending legislation to enact similar state tax credit programs.

New Markets Tax Credits: A Growing Element in Community Development (continued)

Real estate developers involved in an NMTC transaction must understand the technical requirements of the federal and state NMTC Programs and the innovative use of public-private partnerships in this challenging economic climate. Given the implications of failing to comply with these often complex requirements, having experienced advisors to counsel on these matters is critical.

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