
THE REAL ESTATE LAW REVIEW

FOURTH EDITION

EDITOR
DAVID WATERFIELD

LAW BUSINESS RESEARCH

THE REAL ESTATE LAW REVIEW

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THE REAL ESTATE LAW REVIEW

Fourth Edition

Editor
DAVID WATERFIELD

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CONTENTS

Editor's Prefacevii
	<i>David Waterfield</i>
Chapter 1	AUSTRIA 1
	<i>Peter Oberlechmer</i>
Chapter 2	BELGIUM 13
	<i>Yves Delacroix</i>
Chapter 3	BRAZIL..... 29
	<i>Marcelo José Lomba Valença and Tamiris Micheletti Britzki</i>
Chapter 4	CAMBODIA..... 40
	<i>Sophealeak Ing</i>
Chapter 5	CAYMAN ISLANDS 52
	<i>George Loutas</i>
Chapter 6	CHINA 61
	<i>Alex Wang and Edward Hsu</i>
Chapter 7	CROATIA 74
	<i>Hrvoje Vidan</i>
Chapter 8	CYPRUS 88
	<i>Nicolas Th Papaconstantinou</i>
Chapter 9	ENGLAND & WALES 99
	<i>David Waterfield</i>
Chapter 10	FINLAND..... 112
	<i>Samuli Palin and Leif Laitinen</i>

Chapter 11	FRANCE.....	123
	<i>Pierre Gebarowski and Guillaume Rossignol</i>	
Chapter 12	GERMANY.....	138
	<i>Ingo Klöcker</i>	
Chapter 13	GREECE.....	149
	<i>Paraskevi A Anargyrou and Stella G Yannika</i>	
Chapter 14	INDONESIA.....	160
	<i>Eddy Marek Leks</i>	
Chapter 15	IRELAND.....	172
	<i>Kevin Hoy</i>	
Chapter 16	ITALY.....	181
	<i>Alessandro Balp</i>	
Chapter 17	JAPAN.....	192
	<i>Norio Maeda, Tomohiro Kandori, Naoko Katakami, Toshiyuki Yamamoto and Kozo Kuromatsu</i>	
Chapter 18	JERSEY.....	204
	<i>Christopher Philpott and Will Whitehead</i>	
Chapter 19	KOREA.....	216
	<i>Kyung Don Lee, Robert C Young and Eun Nyung Lee</i>	
Chapter 20	LUXEMBOURG.....	233
	<i>Véronique Hoffeld and Marc Meyers</i>	
Chapter 21	NETHERLANDS.....	242
	<i>Annemieke Wessels, Maarten Tinnemans and Max van Drunen</i>	
Chapter 22	NIGERIA.....	254
	<i>Gbolahan Elias and Lynda Chinweokwu</i>	

Chapter 23	NORWAY.....	261
	<i>Thorvald Nyquist</i>	
Chapter 24	POLAND.....	270
	<i>Janusz Siekański and Agnieszka Piskorska</i>	
Chapter 25	PORTUGAL.....	280
	<i>Pedro Ferreirinha</i>	
Chapter 26	QATAR.....	292
	<i>Frank Lucente and Seem Maleh</i>	
Chapter 27	RUSSIA.....	305
	<i>Sergey Kolobov</i>	
Chapter 28	SINGAPORE.....	316
	<i>Jennifer Chia, Cheryl Soh and Priscilla Lim</i>	
Chapter 29	SLOVAKIA.....	332
	<i>Tomáš Zárnecký</i>	
Chapter 30	SPAIN.....	346
	<i>Diego Armero and Rodrigo Peruyero</i>	
Chapter 31	SWITZERLAND.....	359
	<i>Cécile Berger Meyer and Andreas Rötheli</i>	
Chapter 32	TAIWAN.....	372
	<i>Yi-Jiun Su and Yi-Li Kuo</i>	
Chapter 33	TURKEY.....	383
	<i>Barlas Balcıoğlu and Ali Can Gören</i>	
Chapter 34	UNITED ARAB EMIRATES.....	394
	<i>Ibrahim Elsadig and Joe Carroll</i>	

Chapter 35	UNITED STATES	406
	<i>Meredith J Kane</i>	
Appendix 1	ABOUT THE AUTHORS.....	421
Appendix 2	CONTRIBUTING LAW FIRMS' CONTACT DETAILS ...	437

EDITOR'S PREFACE

The fourth edition of *The Real Estate Law Review* is testament to the book's success and the significance of real estate as a global asset class. A great deal has happened since the first edition appeared in 2012, and this fourth edition coincides with renewed confidence in the real estate market. The real estate market is often described as cyclical, and there is no doubt that we are now seeing positive investor sentiment in a market enjoying upward momentum.

The fourth edition of *The Real Estate Law Review* features 35 jurisdictions, and we are delighted to welcome a number of new notable practitioners who have helped bolster the strength and depth of this invaluable publication. Each chapter of *The Real Estate Law Review* has been updated to focus on key developments in that jurisdiction and their impact on the relevant domestic and wider global real estate market. *The Real Estate Law Review* offers real estate practitioners and their clients an immediate and accessible summary of the position in the many countries covered, as well as the global real estate market as a whole. The globalisation of the real estate market continues apace, and it is fundamentally important to develop an understanding of the legal and commercial opportunities and challenges pertinent to each country, and how each local market forms an integral part of the global picture.

This fourth edition seeks to provide an overview of the state of the global real estate investment market. Although there is without question significantly more good news around, the financial and economic turmoil of recent years serves as a reminder of how fragile markets can be, and a number of obstacles remain on what may prove to be a bumpy road to global recovery. Sustainable growth across the eurozone remains illusory, Japan continues to flirt with recession, the fear of a hard landing in China and other developing economies remains, there is continuing instability in Ukraine and the Middle East, and the Ebola outbreak in West Africa is a global concern.

Once again, I wish to express my deep and sincere thanks to all my distinguished colleagues who have contributed to this edition and the success of *The Real Estate Law Review*. I would also like to thank Gideon Robertson and his publishing team for their tireless work in coordinating the contributions and compiling this fourth edition.

David Waterfield

Slaughter and May

London

February 2015

Chapter 35

UNITED STATES

*Meredith J Kane*¹

I INTRODUCTION TO THE LEGAL FRAMEWORK

An investor in US commercial real estate should be familiar with both the type of investment entity that is used for the interest in real estate being acquired by the investor, as well as the type of ownership interest that the investment entity holds in the underlying real property.

i Ownership of real estate

Investors typically hold their interests in US commercial real estate through the following investment entities: a limited liability company (LLC), a limited partnership (LP); a real estate investment trust (REIT); a tenancy in common; or as a direct investment. Each of these investment entities is discussed further in Section IV, *infra*.

The investment entities in turn own the underlying real property asset. The most common forms of ownership of US commercial real estate are fee simple title and ground leasehold title.

In fee simple title ownership, the ownership entity owns all rights, title and interest in the real estate asset, including the right of free alienation of the asset. The fee simple estate is not limited in duration, and there is no superior titleholding estate. A fee simple estate is subject only to liens and encumbrances that are superior to the estate by reason of an express grant of priority by the fee simple owner, such as a mortgage or an easement that expressly encumbers the fee simple estate.

Where a fee simple owner wishes to convey a long-term interest in the real estate asset to a third party but wishes to retain the underlying fee title, typically for reasons of taxes or inheritance, the fee owner will commonly enter into a long-term ground lease that will enable a third party to lease, develop and operate the real estate for the lessee's

¹ Meredith J Kane is a partner at Paul, Weiss, Rifkind, Wharton & Garrison LLP.

account. Ground leases are usually of at least 49 years' duration, and often 99 years or longer. Such long terms are necessary for the ground lessee to finance the development of the real estate and to amortise its equity investment in development of the real estate. A ground lease is a fully net lease, where the lessee develops, finances, operates, maintains and insures the property for its own account. Financing for the acquisition and development of the leasehold interest is secured solely by the lessee's interest in the ground lease, and not by the fee interest itself, which remains superior to the lease and the financing. From the standpoint of the safety of a real estate investment, a ground landlord's position under a ground lease, where the lessee has invested in improving the real estate, is among the most secure investments available.

ii System of registration

The system of registration of real estate titles is governed by the laws of each state. The land title registries for each state are administered by local governments – city, town or county – which are subsidiary governmental jurisdictions in each state. Title registration occurs through the recording of deeds, easements, mortgages and other encumbrances in the local registry offices when a transaction is closed. Recording of title documents is necessary to establish priority and right of estate over other competing interests in the same property. It is customary for a buyer or a lender in US real estate transactions to engage a title insurance company at the time of entering into a contract to purchase property to examine the local title registries to determine the ownership of real estate and any encumbrances of record, and to engage a surveyor to determine land boundaries and locations of improvements and easements. At the closing of title transactions, it is customary to purchase title insurance to insure that good title is being acquired by the purchaser, subject only to identified encumbrances. Title insurance is also required by most mortgage lenders to insure that the lender's mortgage is a first priority lien on the real estate. The premiums for title insurance vary by state, as do specific endorsements that title insurers are permitted to underwrite. Many state and local governments impose transfer and recording taxes and fees on the transfer or recording of real property titles, based on the dollar value of the consideration paid for the real estate being transferred. Transfer taxes can range from a few tenths of a percentage point to up to more than 3 per cent.

iii Choice of law

The laws of each state govern the legal frameworks of both the investment entities and the ownership estates in real property. There is no federal law of real estate applicable uniformly throughout the US to investment entities or forms of ownership in land, other than the commonality of federal income tax law, which helps shape the investment entities used. There is, however, a relatively high degree of uniformity in the state laws governing investment entities, as both limited partnerships and limited liability companies are governed by uniform acts written by uniform law commissions, which have been adopted with little variation as the laws of each state.

Choice of law in real estate transactions can vary based on the transaction document in question. Ownership entities will usually be established either under Delaware law (which has become the standard for sophisticated financing transactions,

including securitised financing) or the law of the state in which the real estate is located. One advantage to forming an entity under the law of the state where the real estate is located is that a Delaware entity will also need to register to do business in the state in which the real estate is located.

Choice of law for deeds and title transfers is always that of the state where the real property is located. For financing transactions, it is common for there to be a split in governing law. Notes and loan agreements are often governed by New York law, which has become a standard commercial jurisdiction for lenders, while security documents, such as mortgages and UCC (Uniform Commercial Code) financing statements, are always governed by the law of the state in which the real estate is located. It is important in mortgage transactions for the lender and borrower to retain local counsel in all states where the mortgaged property is located to ensure that the mortgage documents meet state law requirements and are in proper format to be recorded in the local title registries and enforced under state law.

II OVERVIEW OF REAL ESTATE ACTIVITY

The US real estate market was strong across all property types in 2014, with plentiful debt and equity capital for acquisitions and development. Several factors caused a surge in values and activity in US real estate in 2014:

- a* the continued low long-term interest rates and ‘quantitative easing’ monetary policies of the US central bank;
- b* strong job growth in many sectors, including manufacturing, business services and energy, driving the demand for more office space and residential rental properties;
- c* the relative lack of return opportunities in other investment sectors; and
- d* the attractiveness of the US markets to overseas investors looking for a stable, safe haven for their funds.

The large amount of investment capital seeking real estate deals – both existing assets and development opportunities – has led some observers to conclude that real estate, particularly in the ‘gateway’ cities of New York, Miami and San Francisco, may again have reached unsustainably high ‘bubble’ prices.

The restructuring of large and small loans and equity investments throughout all asset classes that has dominated the US real estate markets since 2008 was relatively smooth in 2014 due to the ready availability of equity and debt capital and strong valuations across real estate asset classes. Substantial refinancing activity is expected to occur during the period from 2015 to 2017, as approximately US\$350 billion in 10-year maturity commercial mortgage backed security debt (CMBS) will need to be refinanced.² The pattern of recapitalisations in recent years has employed substantial new equity infusions, as leverage levels have decreased from first mortgage loan amounts that were commonly at 70 to 75 per cent for stabilised commercial properties in the mid-2000s, to levels that are closer to 50 to 60 per cent in today’s refinancing markets. CMBS issuances

2 Source: Trepp LLC, Real Estate Finance Intelligence, 31 December 2013.

have not fully resumed their pre-financial crisis role as a primary sources for debt refinancing, with banks still providing the bulk of debt capital, followed by CMBS, life insurance companies, GSEs (for multi-family assets) and non-bank sources, including real estate funds and REITs³. CMBS issuances in 2014 are estimated to be approximately US\$100 billion, about the same level as 2013, and less than half of the US\$237 billion issued for US properties in 2007.⁴ Projections for 2015 by market participants estimate at least a 25 per cent increase in CMBS issuances in 2015, as markets are overall bullish on real estate.⁵ However, new regulations adopted under the federal Dodd-Frank Financial Reform Act, which require that issuers retain a minimum of 5 per cent of the risk in future CMBS issuances, are expected to continue to constrain securitisation capacity.⁶

Equity activity in real estate continued to be strong in 2014, as investors sought yield and equity was in demand to cover gaps in the capitalisation structure brought about by reduced loan-to-value ratios. The total of new funds raised by equity property funds was estimated to be in excess of US\$90 billion (about the same as 2013), bringing total assets under management at private closed-end funds to nearly US\$700 billion. 'Dry powder' (uncalled capital commitments to equity funds, evidencing availability of ready capital for investment) reached a high of US\$206 billion in mid-2014, with the greatest availability for United States properties.⁷ These funds include institutional equity commitments to real estate from pension funds, foundations and endowments, large capital sources that in recent years have increased their exposure to real estate in order to increase yield. Institutional investors are still largely focused on 'core' properties with stable yields, but 'value-add' properties included in institutional portfolios as well as strong competition for core properties has driven prices to extremely high levels. Core properties, representing high-quality, well-leased income-generating assets in major cities including Boston, New York, Washington, DC and San Francisco have as a class yielded returns, including capital appreciation, of approximately 12 per cent nationwide in 2014, as compared with 10-year Treasury yields of under 2.5 per cent.⁸ Also taking into account capital appreciation, a key index of open-end core funds shows annualised returns of 13.27 per cent.⁹ For 2015, pension investment managers are predicting increased investment in riskier properties, as tremendous demand for core properties is driving down yields.

New development activity in New York City reached a 10-year high, including both office space and new residential condominium units. Office leasing continues its longest consecutive run on record, also hitting a 10-year high in 2014. Office vacancies dropped by nearly a full percentage point to under 10 per cent availability, and average

3 Source: Pension Real Estate Association, *Compendium of Statistics*, 5 January 2015 (PREA Compendium).

4 Source: Commercial Mortgage Alert, PREA Compendium.

5 Source: Commercial Real Estate Finance Council 2015 Market Outlook Survey.

6 Source: Federal Reserve Board of Governors Press Release, 22 October 2014.

7 Source: Prequin Real Estate Fund Manager Outlook, June 2014.

8 Source: JP Morgan US Core Real Estate Securities Composite Benchmark.

9 Source: NCREIF NFI-ODCE Index, 2013 results.

asking rents increased by over 6 per cent from 2013. Several large office leases were signed at new office developments at Manhattan's Hudson Yards, and downtown's Brookfield Place and World Trade Center complexes.

The most active development sector in New York in 2014 was condominiums, with approximately 9,000 units currently in construction. The average sales prices for condominium units in Manhattan hit US\$2.4 million, a 20 per cent increase over 2013, representing both increased prices per square foot and sales of larger units. Land prices, which have largely been driven by the demand for residential development, including ultra-luxury condominiums (units priced in excess of US\$5000 per square foot), have topped US\$1000 per developable square foot in desirable midtown Manhattan locations, and are also strong in the boroughs of Brooklyn and Queens.

III FOREIGN INVESTMENT

The US commercial real estate markets remain an attractive investment target for foreign capital seeking a stable political environment and stable currency. Commercial real estate remains a relatively attractively priced asset, with the potential to generate substantial operating income and capital gains as markets continue to expand. Total foreign investment in the US real estate was expected to surpass US\$50 billion, or 12.7 per cent of commercial property sales in the US, by the end of 2014, an increase of nearly 25 per cent from the previous year.¹⁰ The major source of foreign capital was Canadian pension funds, which accounted for close to US\$15 billion of direct investment in 2013–14. The fastest investment growth was seen among Chinese investors, who collectively invested US\$7.6 billion in US real estate assets in 2014, up from US\$2.88 billion in 2013.¹¹ Chinese investors, unlike the other pension and sovereign wealth funds, invested heavily in new development projects, including high-profile mixed-use projects in New York and Los Angeles, where yields can top 15 to 20 per cent. Three of the five top global cities for foreign investment dollars are in the US: New York, San Francisco and Houston. The most popular asset types for foreign investments in US real estate, apart from development, are multi-family and industrial, followed closely by retail, office and hotel.¹² The inclusion of San Francisco and Houston on this list, in addition to the traditionally strong office and multi-family markets of New York and Washington, DC (home to financial services and government sectors, respectively), shows the role that the technology and energy sectors have played in leading job recovery in the US economy. Foreign investment in luxury US residential real estate was extremely strong in 2014, with Chinese, Russian, Middle Eastern and Latin American investors leading the way in the gateway cities of New York, San Francisco and Miami. The decline of oil prices at the end of 2014, with its effects on the Russian and Middle Eastern economies, and the slowdown in the growth of the Chinese economy generally, has led to an expectation of a slower pace of luxury US residential purchases in 2015.

10 Source: Pension & Investments, 17 November 2014.

11 Source: Bloomberg Businessweek, 19 November 2013.

12 Source: 2015 Association of Foreign Investors in Real Estate survey.

i Foreign Investment in Real Property Tax Act

Foreign investment in US commercial real estate is generally done through a US-taxpaying entity, in order to avoid the withholding tax provisions of Internal Revenue Code Section 897, the Foreign Investment in Real Property Tax Act (FIRPTA). The most commonly used US-taxpaying entity for foreign investment is a US corporation that is a wholly owned subsidiary of the foreign investor. As with LLCs and LPs, corporations are also organised under state law, usually either Delaware or the state in which the real estate is located. The foreign investor is thus subject to US income tax with respect to the ownership and operations of US real estate, including capital gains taxes on dispositions. While there have been several legislative initiatives to repeal FIRPTA over the past few years in order to encourage foreign investment in US real estate, it remains in effect.

Loan activity by a foreign lender to an unrelated US borrower, where the lender is domiciled outside of the US, and where the loan is sourced and negotiated outside the US, is not subject to US withholding tax.

ii EB-5 Immigration Program for Investment in Job Creation

An incentive for foreign investment that has become increasingly widely used over the past five years is the 'EB-5' programme, under which a foreign national becomes entitled to receive an employment-based fifth preference (EB-5) immigrant visa in return for investing in a new commercial enterprise within a US government-designated 'regional centre'. The required investment is US\$1 million of foreign capital, which is reduced to US\$500,000 for an investment in an area of high unemployment or in a rural area. The investment must create at least 10 full-time US jobs. The EB-5 investment is structured either as a preferred equity investment with a fixed return or as secured debt. EB-5 investment has become a primary source of low-cost investment capital for real estate development projects, where jobs are generated through construction activity as well as business occupancies. China is the main source of EB-5 investment dollars for US real estate transactions, exceeding 70 per cent of the EB-5 applications over the past three years. There is pressure from the real estate industry on the US Congress to expand the number of visas offered under this programme.

IV STRUCTURING THE INVESTMENT

Real estate ownership is typically structured so that an entity with limited liability is the owner of the direct fee title or ground leasehold interest in the real estate. The investors hold interests in these entities, rather than directly owning the title to the real estate. The most common types of limited liability entities that own real estate assets are the LLC, the LP and the REIT.

LLCs and LPs are organised under state laws, most commonly either Delaware law or the laws of the state in which the real estate is located. An LLC is managed by a manager or a managing member, and an LP is managed by a general partner. The investors are typically non-managing members or limited partners in the property-owning entities.

A major advantage of an LLC or LP structure is that an investor is not liable for the debts or liabilities of the title-holding entity beyond the funds invested in the entity. Thus, an investor is insulated from property liabilities through this investment structure,

including property-level debt. A second major advantage is that both LLCs and LPs are 'pass-through' entities for federal income tax purposes, meaning that all income and losses of the entity are passed through to the members and taxed solely to the members, with no second level of tax at the entity level. Investors can use income and losses of the property to offset income and losses of other real estate investments for tax purposes, and tax-exempt investors can enjoy fully tax-exempt income.

Typical provisions of the LP or LLC agreement describe:

- a* the capital contributions of the parties, obligations, if any, of the parties to contribute additional capital to the entity, and rights and remedies if a party fails to make required future contributions;
- b* the decision-making process of the entity, including major decisions that will require approval of all or a majority of the investors;
- c* the timing and priority of distributions of available cash and capital proceeds to the parties, including preferred returns and carried or promoted interests;
- d* allocations of income, gain and loss for tax purposes; and
- e* exit rights of the parties, including buy-sell rights, forced-sale rights, and provisions governing sales of interests and rights of first offer or refusal.

Another relatively common structure for ownership of real estate is the REIT. This structure, defined by Section 856 of the Internal Revenue Code, is used to hold interests in real estate where maximum liquidity is desired. The REIT is organised as a corporation with shareholders, in which the shares may be publicly or privately traded. In order to enjoy a 'pass-through' tax treatment similar to LLCs and LPs, a REIT is required to meet prescribed IRS requirements, including that it distribute 95 per cent of its taxable income annually, that it invest at least 75 per cent of the value of its total assets in real estate or real estate mortgages, and that it derive at least 75 per cent of its gross income from real property rents, interest, proceeds of sale and similar. Most REITs traded on the US markets today are large corporations with multiple property holdings, usually in a single asset class (residential or office), but often in multiple geographic markets to provide asset diversification to REIT investors.

In addition to their advantages as pass-through tax entities, REITs enjoy an advantage in the marketplace for acquisitions because of their ability to finance acquisitions relatively inexpensively. Although REITs are not permitted to retain earnings, REIT property acquisitions are financed with corporate lines of credit, which provide a relatively less expensive source of financing than property-level debt, or by issuance of new stock.

V REAL ESTATE OWNERSHIP

i Planning

Planning and land use issues are largely controlled by states and municipalities through the mechanism of zoning laws adopted by local jurisdictions. In rural and suburban areas, zoning laws centre on master plans for large-scale developments and related infrastructure, with a focus on controlling density, preserving open space and ensuring that there is adequate water, sewer capacity and other necessary utilities for developments.

Preservation of wetlands and natural habitats of endangered plant and animal species are controlled by federal laws, in addition to local zoning laws. In urban areas, zoning laws will prescribe, for each specified zoning district, the uses to which real estate can be put (industrial, commercial, residential or institutional), the density of development (number of square feet of building space per unit of land area), the height, setback and overall architectural configuration of individual buildings, the sizes and configurations of yards and open space, and street frontages. Zoning laws often contain incentives or requirements for developers to provide public goods, such as affordable housing, parks and other public amenities in connection with a new development. Many localities also require preservation of designated landmark buildings. Legal challenges to land use regulations continue to be brought in state and federal courts, which set the limits of how far government can go in regulating the uses to which land can be put without constituting an unconstitutional 'taking' of the private property of the landowner.

ii Environment

Liability of a landowner for contamination of land and water by hazardous substances is governed by both federal and state laws, and enforced concurrently by federal and state governments. The primary federal laws governing hazardous substances liability are the Comprehensive Environmental Response, Compensation and Liability Act and the Resource Conservation and Recovery Act. Both of these statutes make the owner and the operator of land financially and legally responsible for hazardous substance contamination of land that they own or operate, as well as any contamination of neighbouring land or water caused by activities on the land they own or operate. Nearly every state has adopted environmental statutes requiring owners and operators to prepare specific plans for approval by the state environmental agencies for remediation of soil and water contamination caused by hazardous substances. Some states require an approved remediation plan to be in place before an owner can transfer title to any property that was used for industrial use. As part of the due diligence investigation for a property acquisition, a buyer will conduct a Phase I environmental study to determine the past uses of the land, and whether any federal or state environmental violations have been noted. If the Phase I study indicates possible environmental liability, a Phase II study, in which soil and groundwater samples are studied, is customarily undertaken prior to property acquisition. A new buyer of property will become liable for clean-up obligations, even if they have occurred in the past, although the new owner will have the right to claim against the prior owner or operator that caused the contamination.

iii Tax

Many state and local jurisdictions, including towns and counties, impose a transfer tax on transfers of real estate. The amount of tax generally ranges from a few tenths of a percentage point up to more than 3 per cent of the consideration paid for the transfer. Nearly all jurisdictions that impose a transfer tax will tax transfers of fee title. Others will also tax long-term ground leases, transfers of majority interests in entities that own real estate, and transfers of other title interests, including easements, lease assignments and air rights. Some jurisdictions will also tax mortgages based on a percentage of the principal amount. These taxes are paid at the time of transfer and recording of the transfer instrument, and are usually (but not always) imposed on the transferor.

iv **Finance and security**

The most common forms of security for a real estate loan are a mortgage (which creates a security interest for the lender in the real estate) and a mezzanine pledge (which creates a security interest for a lender in the ownership interests in the entity that owns the real estate). A first-priority mortgage is given to the most senior lender, typically with a loan that does not exceed 50 to 75 per cent of the value of the property. If larger amounts are borrowed, the additional loan will be junior in priority to the mortgage loan, and will be secured by a pledge of the ownership interests in the entity that owns the real estate, and not the real estate itself. Thus, when a first mortgage lender forecloses on a mortgage collateral to enforce its loan, it will ultimately hold a sale of title to the property itself to receive repayment on its loan, and will wipe out all junior liens, including a mezzanine pledge, in the event that the sale proceeds are not sufficient to pay off claims. When the mezzanine lender forecloses on its security interest in the ownership entity, it will take title to the ownership interests of the property subject to the mortgage, and the mortgage will remain intact. Both mortgages and security pledges are subject to and enforced under state laws. While details of the enforcement process vary from state to state, lien priority issues are generally similar. In CMBS, where mortgage loans are pooled into a single trust and securities of differing priorities created in the trust, the enforcement of the underlying mortgages follows the same state law process as for single loans.

VI LEASES OF BUSINESS PREMISES

Most occupancy by businesses of retail and office space is done through leasing rather than ownership by the business of the space it occupies. The leasing arrangement allows businesses to have maximum flexibility to expand and acquire more space or relocate geographically as needed, and not to tie up scarce capital in real estate.

i **Office leases**

Typical provisions of office leases are as follows:

Term and renewals

Terms are usually 10 to 15 years, often with options to renew for one or two additional five-year periods.

Base rents and operating expenses

Base rents are either fully net, where the tenant pays a base rent plus its *pro rata* share of all operating expenses and real estate taxes attributable to the property, or pays a base rent plus its *pro rata* share of increases in operating expenses and real estate taxes over a stipulated base amount. Base rents will increase on an annual basis, or will increase cumulatively over a five-year period, at a stipulated amount sized to keep pace with anticipated inflation.

Tenant improvements

An office landlord will pay for initial improvements to the office space, or a provide an allowance to the tenant to pay for improvements, and will provide a period of free rent

at the beginning of the lease to enable a tenant to complete the work and move in. The cost of these concessions is factored into the rent.

Assignment and sub-letting

Tenants may be permitted to sub-let with landlord approval, with criteria as to creditworthiness of the successor, and non-competition with the landlord's leasing of the building. The tenant will usually be required to give or share any sub-lease profits with the landlord. Tenants are not relieved from lease liability by assigning or sub-letting, but remain jointly and severally liable with the sub-tenant.

Building services

Tenants will often be required to purchase building services, such as electricity, cleaning, air conditioning and building management, through the landlord.

Default and termination

If a tenant defaults in lease performance, a landlord may terminate the lease and evict the tenant by court order from possession of the premises. Even after a lease is terminated and the tenant evicted, the tenant will remain liable for damages equal to the rent under the lease until the landlord finds a replacement tenant (and will thereafter remain liable to pay any shortfall between the lease rent and the new rent).

ii Retail leases

Retail leases differ from office leases in the following respects:

Base rent

Base rent is usually fully triple-net, and tenants are responsible to pay a *pro rata* share of property operating expenses and real estate taxes from dollar one, rather than over a stipulated base amount.

Percentage rent

Retail rents commonly include 'percentage rents', in which tenants pay, in addition to base rent and operating expenses and taxes, a percentage of their adjusted gross sales proceeds over a breakpoint. This enables a landlord to offer a lower going-in base rent, and to share in the upside if sales are robust.

Common area maintenance charges

In shopping malls and other retail centres where there are large common areas, and tenants benefit from common marketing and promotional activities, there is also a CAM, or common area maintenance charge, paid *pro rata* by tenants.

Use clauses and continuous operation covenants

Retail leases, particularly in shopping centres, generally contain strict use clauses identifying the image, branding and products to be carried by the retailer, as well as minimum and maximum hours of operation and a covenant to operate without interruption. Both landlord and tenant will expect radius restrictions on competing operations – the tenant will be restricted from having another identical brand store

within a specified radius from the shopping centre, and the landlord will be restricted from having competing brands within the shopping centre, to help ensure the success of the retail operations.

VII DEVELOPMENTS IN PRACTICE

Following are some of the major recent developments in US real property law and practice.

i CMBS loan originations and securitisation

There is an ongoing rethinking of all aspects of lending practices in the CMBS market in response to the default and workout experiences over the past four years. On the loan underwriting side, improved protections of 'CMBS 2.0' include higher debt service coverage ratios, lower loan-to-value ratios, and more conservative cap rate analysis and property valuations. On the securitisation side, protections include higher credit enhancement requirements, deeper junior tranches to support 'super-senior' tranches and enhanced regulatory requirements, including the 5 per cent issuer risk retention described above. On the legal and structural side, protections include the use of an 'operating adviser' to represent the interests of all bondholders while a loan is in special servicing, transfer of the 'controlling class' rights based on appraisal rather than realised reductions in portfolio value to better align decision-making with the first-loss position, and a move towards uniform representations and warranties.¹³ There has also been increasing focus on conflicts of interests between special servicers on CMBS portfolios and the bondholders whom they represent, while CMBS loans continue to be worked out.

ii Bankruptcies

The trend in mortgage financing during the lending boom earlier in the decade was to establish single-purpose entity (SPE) borrowers that owned only the mortgaged asset, and would not be consolidated with other entities in the event of an insolvency. In the case of a loan default, the borrower entities were discouraged from filing for bankruptcy through use of springing recourse guaranties and various SPE provisions, including independent directors. Despite these anti-bankruptcy provisions, a number of multi-asset real estate companies have over the past few years sought bankruptcy reorganisation for the company as a whole, and filed their SPE asset-holding borrowers in bankruptcy as well. Some notable legal principles to emerge from recent high-profile real estate bankruptcies are that:

- a SPE borrowers that are part of an integrated operating group of companies may consider the interests of the entire group in determining to file for bankruptcy, and need not themselves be insolvent at the time of filing;¹⁴ and

13 Source: Fitch Ratings, Structured Finance, 'CMBS 1.0... 2.0... 3.0 ...But Are We Progressing?', 4 January 2012.

14 *In re General Growth Properties, Inc, et al* (Bankr SDNY, Case No. 09-11977).

- b* it does not constitute bad faith for an SPE entity to replace its independent directors installed for the purpose of discouraging a filing, and replacing them with new directors willing to file if in the best interests of the operating group.¹⁵

iii Enforcement of non-recourse carve-out guaranties

One of the most effective means for lenders to prevent a borrower from filing bankruptcy is to require a principal of the borrower to give a 'bankruptcy springing recourse guaranty' as part of the loan, under which the guarantor assumes full personal liability for the entire amount of an otherwise non-recourse debt if the borrower voluntarily files for bankruptcy or colludes in an involuntary bankruptcy filing. In several decisions across the US in the past year, courts have upheld the validity of bankruptcy springing recourse guaranties against the guarantors, holding that they:

- a* are not void as *ipso facto* clauses under the Bankruptcy Code, but are rather a legitimate and permissible mode of bankruptcy-remote structuring;¹⁶
- b* are not void as *in terrorem* clauses, but create an important deterrent effect to the behaviour sanctioned;
- c* do not constitute a penalty, or unenforceable liquidated damages, but represent an agreement to pay a valid debt of a sum certain;¹⁷
- d* do not induce breach of fiduciary duty or set up a conflict of interest for directors, whose duties are to the company and its shareholders and creditors, and not to the guarantor;¹⁸ and
- e* are not void on public policy grounds favouring bankruptcy, because the real estate financial markets, consisting of powerful and sophisticated business interests, created another paradigm for dealing with lending risk and remedies that was designed to avoid bankruptcy courts.¹⁹

15 Ibid.

16 See *First Nationwide Bank v. Brookhaven Realty Assoc*, 223 AD 2d 618 (NY App Div. 2d Dept 1996), finding that a bankruptcy full recourse guaranty was enforceable as written, even if no damages arise as result thereof; *Bank of America, NA v. Lightstone Holdings LLC and Lichtenstein Bank*, No. 09-01353 (SDNY 2009), finding that it is legitimate to carry out bankruptcy-remote structuring.

17 See *CSFB 2001-CP-4 Princeton Park Corporate Center LLC v. SB Rental I LLC*, 410 NJ Super 114 (NJ Super 2009), upholding full guarantor recourse (in a non-bankruptcy carve-out situation) on the grounds that repayment of debt is actual damages, not liquidated damages, and carve-out just sets terms of liability rather than setting a measure of damages.

18 See *UBS v. Garrison Special Opportunities Fund* (Sup Ct NY County, Index No. 652412/2010), finding that there is 'no distinction between this set of facts and those involving any parent corporate guaranty of a debt of a subsidiary', and that such guaranties are a 'common commercial arrangement not subject to question'.

19 See *FDIC v. Prince George Corp*, 58 F3d 1041 (4th Cir 1995), finding that a carve-out guaranty did not prevent a borrower from filing, but a guarantor would merely forfeit its exemption from liability for any deficiency.

iv Mezzanine lender enforcement of remedies and intercreditor agreements

Mezzanine loans, which are structurally junior debt to first mortgage loans and have as collateral a pledge of the ownership interests in the entity that owns real estate, are governed in part by intercreditor agreements with mortgage lenders entered into at the time of the financing of the property. Under a typical intercreditor agreement, a mezzanine lender is permitted to foreclose its collateral in the event of a mezzanine loan default and, following foreclosure, to ‘step into the shoes’ of the borrower under the mortgage loan, without triggering a mortgage default. Once the mezzanine lender takes over the interests in the borrower entity, the mezzanine lender becomes liable to cure any defaults that were outstanding under the mortgage loan as of the foreclosure, to the extent susceptible of cure by the mezzanine lender. In at least two important recent decisions, state courts in New York and Arizona have refused to let mezzanine lenders foreclose their collateral unless all pre-existing mortgage defaults were cured prior to the mezzanine foreclosure, rather than following.²⁰ The effect of these decisions is to place significant obstacles in the path of the mezzanine lender attempting to foreclose its collateral, and to give the first mortgage lender significant leverage in workout negotiations.

v Distressed debt acquisition as an investment opportunity

Investors looking to acquire real estate assets at a bargain price have increasingly turned to purchases of distressed debt as a means to accomplish this. Bank lenders who hold distressed debt often find it advantageous for regulatory purposes to sell distressed debt at a discount rather than to retain the debt and reserve against it. Borrowers likewise have sometimes found new owners of the debt more able and willing to renegotiate a workout, since the new owners, having acquired the debt at a discount, are in a position to profit from a workout. Buyers of distressed debt must do substantial due diligence about the underlying real property asset and its value, the structural position of the debt (mortgage or mezzanine, or CMBS security), the type of security for the debt and any perfection problems in the security. Purchasers must also be knowledgeable of legal issues in debt enforcement that will affect the dynamics of the workout negotiations among the lender, any senior or junior lenders, and the borrower, such as the mezzanine foreclosure issues described above.

vi Land use planning and climate change: ‘resilient’ planning and building

Hurricane Sandy, which struck New York and surrounding areas with lethal force in September 2012, has led New York and much of the Northeast region to undertake a major reconsideration of land-use patterns, waterfront development and building design

20 *Bank of America, NA v. PSW NYC LLC*, 918 NYS2d 396 (2010) (enjoining the mezzanine lender from foreclosing on its equity interest in the mortgage borrower until after such lender cured all defaults under the senior loan, which included paying the accelerated balance of the loan totalling near US\$3 billion); *US Bank Nat'l Assoc v. RFC CDO 2006-1, Ltd.*, Case No. 4:11-cv-664, Doc. No. 41 (D Ariz 6 December 2011) (enjoining the mezzanine lender from foreclosing on its equity interest in the mortgage borrower after the mezzanine lender failed to cure all defaults under the senior loan).

and codes to enhance ‘resiliency’ in the face of long-term climate change. New York had not seen earlier major damage from environmental disasters prompted by global climate change, and the Manhattan, Brooklyn and New Jersey waterfronts were among the most active markets for new residential development. With much of New York’s energy and transportation infrastructure temporarily disabled by the 2012 hurricane, and thousands of residential units around the region and millions of square feet of lower Manhattan office space rendered unoccupiable for more than 60 days following the hurricane, new technologies to prevent long-term damage to both public and building infrastructure from increasingly severe storm patterns are being developed, and zoning and building code changes are being implemented. On the building front, resiliency improvements include installation of back-up generators and flood gates, raising the location of building equipment and creating flood reservoirs in basements. On the city-wide level, resiliency reforms include redrawing flood zones, which will affect insurance costs and availability, retooling and waterproofing the electrical, transportation and communications grids, and rethinking waterfront zoning and development patterns.

VIII OUTLOOK AND CONCLUSIONS

The prospects for the US real estate market in 2015 remain strong, with value improvements and increased transaction volume expected throughout markets across the United States. The core central business districts – New York, San Francisco, Houston, Seattle and Washington, DC – have seen more rapid increases in values and transaction volume than other areas of the country, and are expected to continue to see strong increases in 2015. Residential markets in these core areas, both multi-family rentals and condominiums, have extremely strong transaction volumes and prices. New development of office and residential products in these cities attract foreign investment capital as well as foreign buyers. Existing core and value-add properties attract major institutional investors.

Rents, asset values and transaction volumes have increased in other regions in the United States as well, as the US economy continues to rebound overall and jobs increase, including in the manufacturing sector. The US housing market overall has stabilised tremendously over earlier years, as the overhang of foreclosed properties that depressed prices and sales volumes has eased, through a lessened volume of new foreclosures and acquisitions by private equity funds of large quantities of single-family homes for rental occupancy. Although interest rates remain at historic lows, mortgage underwriting standards have increased such that the total volume of new loans and refinancings remains below expectations.

The overall outlook for 2015 is for increased equity investment in core office and multi-family assets in core markets by both domestic and foreign investors. The pace and value of growth and new real estate development, however, is directly dependent on the status of the overall US and global economies. The US outlook also is highly dependent on federal government fiscal and regulatory policy, including budget and tax policy debates in the US Congress.

Appendix 1

ABOUT THE AUTHORS

MEREDITH J KANE

Paul, Weiss, Rifkind, Wharton & Garrison LLP

Co-chair of the real estate department at Paul, Weiss, Rifkind, Wharton & Garrison LLP and a member of the firm's management committee, Meredith Kane's experience includes all aspects of development, finance, acquisitions and sales, equity joint ventures, restructuring, leasing and securitisation of real estate. Ms Kane has represented a long list of public entities and private companies in major real estate transactions in New York.

Ms Kane was Commissioner of the New York City Landmarks Preservation Commission from 1995 to 2004. She currently serves on the boards of the Lower Manhattan Cultural Council, the Forum for Urban Design, the New York Foundation for Senior Citizens, the Association to Benefit Children, the Olana Partnership and the Avenue of the Americas Association (which she chaired from 1999 to 2007). Ms Kane is a member of the Real Estate Board of New York, WX-Women Executives in Real Estate, the New York Women's Forum, the ULI-Urban Land Institute and the Association of the Bar of the City of New York (former chair, Economic Development Subcommittee, Land Use Planning and Zoning Committee). She serves as co-chair of the New York State Bar Association's Advanced Real Estate Practice annual conference.

Ms Kane was honoured as the 2012 'Best in Real Estate' at the Euromoney Legal Media's inaugural Americas Women in Business awards, 2009 Woman of the Year by WX – New York Women Executives in Real Estate, and was named one of the top 50 women in real estate and one of 25 current leaders in the industry by *Real Estate Weekly* and the Association of Real Estate Women. *Grid Magazine* named her one of the top 10 American women in real estate development. She is cited as one of the leading real estate lawyers in the United States in *Chambers USA*, *Who's Who Legal USA*, the *Legal 500*, *The Best Lawyers in America* and numerous other peer-reviewed publications. She is a member of the prestigious American College of Real Estate Lawyers.

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

1285 Avenue of the Americas

New York

NY 10019-6064

United States

Tel: +1 212 373 3065

Fax: +1 212 492 0065

mjkane@paulweiss.com

www.paulweiss.com