The Real Estate Law Review

Fifth Edition

Editor
John Nevin

Law Business Research

The Real Estate Law Review

The Real Estate Law Review
Reproduced with permission from Law Business Research Ltd.

This article was first published in The Real Estate Law Review - Edition 5
(published in February 2016 – editor John Nevin)

For further information please email
Nick.Barette@lbresearch.com

The Real Estate Law Review

Fifth Edition

Editor
John Nevin

Law Business Research Ltd

PUBLISHER
Gideon Roberton

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

SENIOR ACCOUNT MANAGERS
Thomas Lee, Felicity Bown, Joel Woods

ACCOUNT MANAGER
Jessica Parsons

MARKETING COORDINATOR
Rebecca Mogridge

EDITORIAL ASSISTANT
Sophie Arkell

HEAD OF PRODUCTION
Adam Myers

PRODUCTION EDITOR
Robbie Kelly

SUBEDITOR
Gina Mete

CHIEF EXECUTIVE OFFICER
Paul Howarth

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

www.TheLawReviews.co.uk

ISBN 978-1-909830-85-1

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

THE LAW REVIEWS

THE MERGERS AND ACQUISITIONS REVIEW

THE RESTRUCTURING REVIEW

THE PRIVATE COMPETITION ENFORCEMENT REVIEW

THE DISPUTE RESOLUTION REVIEW

THE EMPLOYMENT LAW REVIEW

THE PUBLIC COMPETITION ENFORCEMENT REVIEW

THE BANKING REGULATION REVIEW

THE INTERNATIONAL ARBITRATION REVIEW

THE MERGER CONTROL REVIEW

THE TECHNOLOGY, MEDIA AND TELECOMMUNICATIONS REVIEW

THE INWARD INVESTMENT AND INTERNATIONAL TAXATION REVIEW

THE CORPORATE GOVERNANCE REVIEW

THE CORPORATE IMMIGRATION REVIEW

THE INTERNATIONAL INVESTIGATIONS REVIEW

THE PROJECTS AND CONSTRUCTION REVIEW

THE INTERNATIONAL CAPITAL MARKETS REVIEW

THE REAL ESTATE LAW REVIEW

THE PRIVATE EQUITY REVIEW

THE ENERGY REGULATION AND MARKETS REVIEW

THE INTELLECTUAL PROPERTY REVIEW

THE ASSET MANAGEMENT REVIEW

THE PRIVATE WEALTH AND PRIVATE CLIENT REVIEW

THE MINING LAW REVIEW

THE EXECUTIVE REMUNERATION REVIEW

THE ANTI-BRIBERY AND ANTI-CORRUPTION REVIEW

THE CARTELS AND LENIENCY REVIEW

THE TAX DISPUTES AND LITIGATION REVIEW

THE LIFE SCIENCES LAW REVIEW

THE INSURANCE AND REINSURANCE LAW REVIEW

THE GOVERNMENT PROCUREMENT REVIEW

THE DOMINANCE AND MONOPOLIES REVIEW

THE AVIATION LAW REVIEW

THE FOREIGN INVESTMENT REGULATION REVIEW

THE ASSET TRACING AND RECOVERY REVIEW

THE INTERNATIONAL INSOLVENCY REVIEW

THE OIL AND GAS LAW REVIEW

THE FRANCHISE LAW REVIEW

THE PRODUCT REGULATION AND LIABILITY REVIEW

THE SHIPPING LAW REVIEW

THE ACQUISITION AND LEVERAGED FINANCE REVIEW

THE PRIVACY, DATA PROTECTION AND CYBERSECURITY LAW REVIEW

THE PUBLIC-PRIVATE PARTNERSHIP LAW REVIEW

THE TRANSPORT FINANCE LAW REVIEW

THE SECURITIES LITIGATION REVIEW

THE LENDING AND SECURED FINANCE REVIEW

THE INTERNATIONAL TRADE LAW REVIEW

THE SPORTS LAW REVIEW

www.TheLawReviews.co.uk

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

ALI BUDIARDJO, NUGROHO, REKSODIPUTRO

AL TAMIMI & COMPANY

ASBZ ADVOGADOS

BALCIOĞLU SELÇUK AKMAN KEKİ

BONELLI EREDE PAPPALARDO

BUN & ASSOCIATES

CAREY OLSEN

CMS REICH-ROHRWIG HAINZ

DE BRAUW BLACKSTONE WESTBROEK NV

DELOITTE ADVOKATFIRMA AS

DENTONS

DE PARDIEU BROCAS MAFFEI

G ELIAS & CO

HENGELER MUELLER

HERBERT SMITH FREEHILLS LLP

IGLESIAS, POZAS Y PÁEZ

LEE AND LI, ATTORNEYS-AT-LAW

LENZ & STAEHELIN

LETT LAW FIRM

LIEDEKERKE WOLTERS WAELBROECK KIRKPATRICK

MAPLES AND CALDER

M & P BERNITSAS LAW OFFICES

NISHIMURA & ASAHI

ODVJETNIČKO DRUŠTVO BARDEK, LISAC, MUŠEC, SKOKO D.O.O.
IN COOPERATION WITH CMS REICH-ROHRWIG HAINZ

PAPADOPOULOS, LYCOURGOS & CO LLC

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

PETRIKIĆ & PARTNERI AOD IN COOPERATION WITH
CMS REICH-ROHRWIG HAINZ

SHIN & KIM

SLAUGHTER AND MAY

SOŁTYSIŃSKI KAWECKI & SZLĘZAK

TSMP LAW CORPORATION

URÍA MENÉNDEZ

VIEIRA DE ALMEIDA & ASSOCIADOS, RL

WOLF THEISS ATTORNEYS AT LAW

ZÁRECKÝ ZEMAN

CONTENTS

EDITOR'S PREFACE

I am honoured to have been invited to take over from David Waterfield as editor of *The Real Estate Law Review* and I would like to take this opportunity to personally thank David for his invaluable help and support over the years and, on behalf of *The Real Estate Law Review*, for his vital role in its success since the first edition back in 2012.

Building on the success of the previous editions of the *Review*, the fifth edition now extends to some 38 jurisdictions, and we are delighted to welcome new contributors from important jurisdictions around the world. Each contributor is a distinguished legal practitioner in his or her jurisdiction with an in-depth understanding of both his or her own domestic market and the wider global real estate market. Each chapter offers an essential guide to real estate practice in the relevant jurisdiction together with an invaluable focus on market activity, important legal and practical developments over the preceding 12 months and the outlook for 2016. Together, the chapters offer real estate practitioners and their clients an immediate and accessible overview of international real estate.

Real estate is a truly global industry and it is no longer possible to look at domestic markets in isolation. It has become essential to develop an understanding of the needs and expectations of overseas investors, and of how domestic markets are affected by legal, economic, political and social events and trends throughout the world. International economic and political instability continue to have a significant effect on the international real estate market and this is reflected in investors' pursuit of value and security. The United Kingdom (and London in particular) continues to be seen as a safe haven for capital from around the world, and the outlook here remains buoyant in both the commercial and residential sectors.

I wish to express my gratitude to all the distinguished practitioners from across the globe who have contributed to this fifth edition, and thereby to the continued success of *The Real Estate Law Review*. I would also like to take this opportunity to thank Gideon Roberton and his team for their sterling efforts in coordinating the contributions and compiling this edition.

John Nevin
Slaughter and May
London
February 2016

Chapter 38

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 title-holding 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 United States 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 2015, with plentiful debt and equity capital for acquisitions and development. Total US deal volume (property bought and sold) totalled US$533 billion in 2015, up 23 per cent from 2014.[2] Several factors caused a surge in values, and a surge in activity, in US real estate in 2015: the continued low long-term interest rates and monetary policies of the US central bank; strong business growth in many sectors, including manufacturing, business services and warehousing, driving the demand for more office and warehouse space and residential rental properties; the relative lack of return opportunities in non-real estate investment sectors; and 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 so-called 'gateway' cities of New York, Los Angeles and San Francisco, may again have reached unsustainably high 'bubble' prices. Indeed, pricing increases showed a marked slowdown in the fourth quarter of 2015.

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 2015, because of the ready availability of equity and debt capital and strong valuations across real estate asset classes. Substantial refinancing activity is expected to occur during 2016–2017, as approximately US$220 billion in 10-year maturity commercial mortgage backed security debt (CMBS) will need to be refinanced.[3] The bulk of refinancings are in the office sector, with over US$116 billion pending.[4] The pattern of recapitalisations in recent years has employed substantial new equity infusions,

2 Source: Real Capital Analytics, Commercial Real Estate Market Trends, January 2016; Trepp Talk, 28 January 2016.

3 Source: Trepp LLC, Scotsman Guide, 8 July 2014.

4 Ibid.

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. Approximately 35 per cent of office refinancings, and 45 per cent of retail refinancings, are expected to be recapitalised with additional equity. CMBS issuances, totalling US$95.1 billion in 2015, while not at the absolute dollar level of the pre-financial crisis, have resumed their pre-financial crisis role as a major source for debt refinancing, with CMBS providing 21 per cent of real estate debt capital for 2015 (down from 27 per cent in 2014.)[5] Banks are still providing the bulk of debt capital to the real estate markets, at 31 per cent (nearly evenly split between domestic and foreign banks), followed by 'private or other' sources at 18 per cent, followed by life insurance companies, government-sponsored enterprises (for multifamily assets), and non-bank sources, including real estate funds and real estate investment trusts (REITs).[6] CMBS issuances in 2016 are expected to continue to grow, as markets are bullish overall on real estate. However, recent 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.[7]

Equity activity in real estate continued strongly in 2015 as investors sought yield and equity was in demand to cover gaps in the capitalisation structure brought about by reduced loan-to-value ratios. Total assets under management at private closed-end equity property funds totalled an all-time high of US$742 billion in 2014, and continued to post strong and steady returns, with over 17 straight quarters of net asset value growth as of June 2014.[8] Real estate funds generated annualised returns of 16.7 per cent over the three years from 2011–2014, with strong performance continuing through 2015. 'Dry powder' – uncalled capital commitments to equity funds, evidencing availability of ready capital for investment – reached a high of US$252 billion in 2015, up from US$206 billion in 2014, with the greatest availability for US properties.[9] 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 to increase yield. Institutional investors are still largely focused on 'core' properties with stable yields, but 'value-add' properties are included in institutional portfolios, and 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 as of mid-2015, including capital appreciation, of approximately 13 per cent, of which approximately 8 per cent represents capital appreciation and

5 See footnote 2.

6 Source: Real Capital Analytics, Commercial Real Estate Market Trends, January 2016.

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

8 Source: 2015 Preqin Global Real Estate Report.

9 Source: Real Capital Analytics, Commercial Real Estate Market Trends, January, 2016, Preqin Fund Manager Outlook 2015.

5 per cent represents income.[10] This compares with a return on US Treasury bonds of about 2.5 per cent. For 2016, investors are projecting substantially slower growth and diminished returns, down to approximately 9 per cent combined returns, as interest rates gradually return to more normal levels, and the underlying world economic condition hits headwinds, specifically in the worldwide energy sector and in the Chinese markets.

New development activity in New York City reached a 10-year high, including both office space and new residential condominium units. With about 31 million square feet of office space leased, office-leasing activity was 8.4 per cent above the 10-year historical average for New York City, but down 16.1 per cent from its peak in 2014. Office rents, however, continued to climb to an all-time high of US$71.50 per square foot average asking rate in Manhattan. The strongest sectors were finance, insurance and real estate, at 36 per cent of square footage leased, followed by technology and media, at 23 per cent.[11] 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, signalling the broadening central business district locations in Manhattan.

The most active development sector in New York City in 2015 was condominiums, with approximately 6,500 new condo units in Manhattan expected to open for sales across more than 100 buildings in 2015, as opposed to about 2,500 units in 59 buildings in 2014.[12] The median sales prices in 2015 for condominium units in Manhattan increased 17.4 per cent from 2014, with an average sales price of approximately US$2 million. Pricing was pushed up by closings of ultra-luxury condominiums, with a 78 per cent increase in closings over US$5 million, as several new developments begun in the past two years in this market reached construction completion.[13]

Land prices, which have largely been driven by the demand for residential development, including ultra-luxury condominiums (units priced in excess of US$5,000 per square foot), have topped US$1,000 per developable square foot in desirable midtown Manhattan locations, and have reached all-time highs in the boroughs of Brooklyn and Queens as well. For 2016, considerable slowing will be seen in land price increases, as the ultra-luxury condominium market, which is highly dependent on foreign ultra-high-net-worth buyers, is widely seen as being saturated, at least for the time being.

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

---

10 Source: Real Capital Analytics, Commercial Real Estate Market Trends, January 2016; PREA Consensus Survey, April 2015.

11 Source: Colliers Market Report: Manhattan Office, 2015.

12 Corcoran Sunshine Marketing Group, cited in *The New York Times*, 2 January 2015, 'Year of the Condo'.

13 Source: Elliman – Miller Samuel Manhattan Condo Report Q4 2015.

substantial operating income and capital gains as markets continue to expand. Total direct foreign investment in US real estate surpassed US$91.1 billion, or 17.1 per cent of the transaction volume last year, up from the 10 per cent average in each of the previous four years. The major source of foreign capital was Canadian pension funds, which accounted for US$24.6 billon of direct investment in 2015, including the purchase of the US$5.3 billion Stuyvesant Town multifamily community in Manhattan in December 2015. Investors from Singapore accounted for the second largest piece of foreign investment, completing US$14.8 billion of deals in 2015. Norway followed with US$8.5 billion of deals, and Chinese investors completed US$6.8 billion of deals.[14] Three of the five top global cities for foreign investment dollars are in the United States: New York, San Francisco, and Houston. The most popular asset types for foreign investments in US real estate, apart from development, are multifamily and warehouse, followed closely by central business district office and regional malls.[15] The inclusion of San Francisco and Houston on this list, in addition to the traditionally strong office and multifamily markets of New York and Washington, DC (home to financial services and government sectors, respectively), shows the role that the technology and energy sectors play as major job sources in the US economy. Foreign investment in luxury US residential real estate remained strong in 2015, 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 throughout 2015, 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 much slower pace of luxury US residential purchases in 2016. Additionally, a programme announced by the federal government in cooperation with New York City, will require disclosure of individual owners behind all-cash, luxury-apartment purchases.

i Foreign Investment in Real Property Tax Act

Foreign investment in US commercial real estate is generally done through a US-taxpaying entity, 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 the US income tax with respect to the ownership and operations of US real estate, including capital gains taxes on dispositions. At the end of 2015, long-sought amendments to FIRPTA were enacted into law, expanding exemptions from US taxes for foreign pension funds that invest in US REITs or directly in real estate, thus putting foreign pension funds on a similar tax footing to that for US-based pension funds. This change is intended, and expected, to increase foreign pension fund investment in US real estate.

14 See footnote 2.

15 Source: 2015 Association of Foreign Investors in Real Estate (AFIRE) survey.

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

ii 'EB-5' immigration programme 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. The EB-5 programme came under fire in the US Congress this past year, as Congress sought to roll back the perceived ease of obtaining a visa through this programme. However, the programme was extended unchanged for an additional year, through September 2016, largely as a result of strong lobbying by the real estate industry.

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. To enjoy a 'pass-through' tax treatment similar to LLCs and LPs, a REIT is required to meet prescribed Internal Revenue Service 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 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 subletting
Tenants may be permitted to sublet 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 subtenant.

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.[16] 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 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;[17] and

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.[18]

---

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

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

18 Ibid.

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;[19]

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;[20]

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;[21] 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.[22]

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

19 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.

20 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.

21 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'.

22 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.

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.[23] 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 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

23 *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 the 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).

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 2016 remain strong; however, with expectation for lower growth and greater stabilisation in values and returns 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 but are expected to moderate in 2016. Residential markets in these core areas, both multifamily 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 have begun a slow ascent from the historic lows of recent years, the Federal Reserve is moving cautiously to avoid choking off needed growth, and the total volume of new loans and refinancings has increased over prior years.

The overall outlook for 2016 is for continued, but not necessarily increased, equity investment in core office and multifamily 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, including the flows of international capital, and the relative returns available in other investment sectors. The US outlook also is highly dependent on federal government fiscal and regulatory policy, including the direction of the 2016 national elections.

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 Urban Design Forum, 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 Practising Law Institute's 'CMBS and the Real Estate Lawyer' 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
United States
Tel: +1 212 373 3065
Fax: +1 212 492 0065
mjkane@paulweiss.com
www.paulweiss.com