# AFIRE
# Guide to US Real Estate
# Investing

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UNDER THE LEADERSHIP OF
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# Introduction

William B. Fryer, King & Spalding LLP

The Association of Foreign Investors in Real Estate (AFIRE) is pleased to update its *AFIRE Guide to US Real Estate Investing*, last published in 2003. The *Guide* has proven to be an invaluable resource not only to those new to the US real estate market, but also to experienced investors for whom it is a ready resource. We hope that you agree with us that the *Guide* encompasses the spectrum of topics relevant to institutional investors with US commercial real estate portfolios and proves to be for you an efficient and useful tool in your US real estate investment endeavors.

While much of the *Guide* is still devoted to direct property acquisition, ownership and disposition, it also addresses, at least in general terms, various other conduits through which AFIRE's members have increasingly deployed their capital into US real estate. The *Guide* has also been freshened to include topics of particular current interest in these tumultuous times of global financial crisis and recession, such as investments in debt instruments and principles of US insolvency and bankruptcy.

It should be noted that the *Guide* is intended to provide an overview of the topics covered in practical rather than purely technical terms, although there is much substance addressed in each of its chapters that will likely prompt your interest to delve deeper into the subjects especially relevant to your own investment focus.

The *Guide* approaches the real estate exercise from a variety of perspectives, including the relevant legal framework, tax planning, accounting principles, and a wide variety of business considerations.

AFIRE is fortunate to have as authors of the *Guide* extremely knowledgeable and experienced practitioners with high profiles in the US commercial real estate industry, many of them reprising a chapter from the last publication of the *Guide*. All of these authors are very active in the current market and bring insight to their papers from literally decades of experience, in most cases, over the inevitable up and down cycles of the real estate industry. AFIRE is grateful to our authors and thanks them for their respective contributions to our updated *Guide*.

This updated *Guide* would also not be possible without the substantial work of my partner, Sebastian Kaufmann, who not only authored a chapter to the updated *Guide*, but also served as the principal editor for the entire updating exercise.

Finally, AFIRE is truly indebted to Richard Crystal of Seyfarth Shaw LLP as editor of the original *Guide*, in addition to authoring one of the chapters in the current *Guide*. As evidence of the high quality of Richard's editorial work on the original *Guide*, virtually all of the carryover chapters remain largely intact and have set a high bar for the chapters added to this refreshed version. Richard, thank you for your leadership contribution to AFIRE.

**William B. Fryer, Partner, King & Spalding LLP**

Bill Fryer is a long time partner of King & Spalding LLP whose practice focus is within the global capital markets of the commercial real estate industry. He currently serves on the executive committee of the board of directors of AFIRE. He received his BA (with high distinction) and JD (Order of the Coif) from the University of Virginia for which he continues to serve as a trustee of various university-related foundations.

# Chapter 1

## ENTERING THE US MARKET: CHOOSING A STRATEGY

David J. Lynn and Tim Wang, with assistance from Bohdy Hedgcock, ING Clarion Partners

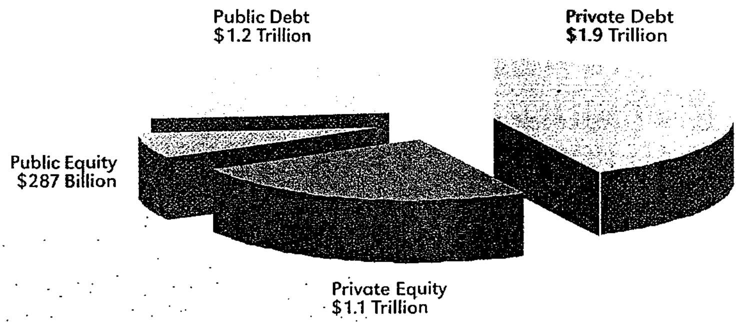
### Investing in US Commercial Real Estate

Commercial real estate has been increasingly recognized as an asset class by institutional investors over the past 15 years because of its high current cash flow, diversification benefits and as a hedge against inflation. Broadly speaking, the universe of commercial real estate investment opportunities can be divided into four categories based on whether the properties are held in public or private market vehicles and whether the investment structures are equity or debt. This "Four Quadrant Model," shown in Exhibit 1, illustrates the range of real estate investment

**EXHIBIT 1: FOUR QUADRANTS OF REAL ESTATE INVESTMENT**

| | EQUITY | DEBT |
|---|---|---|
| PRIVATE | Direct investment in real estate | Direct investment in real estate mortgages |
| PUBLIC | Real estate investment trusts (REITs)<br>Real estate operating companies (REOCs) | Commercial mortgage backed securities (CMBS) |

EXHIBIT 2: MARKET SIZE OF THE REAL ESTATE INVESTMENT UNIVERSE




*Sources: ING Clarion Research & Investment Strategy, Federal Reserve, National Association of Real Estate Investment Trusts, Property & Portfolio Research, as of June 30, 2008*

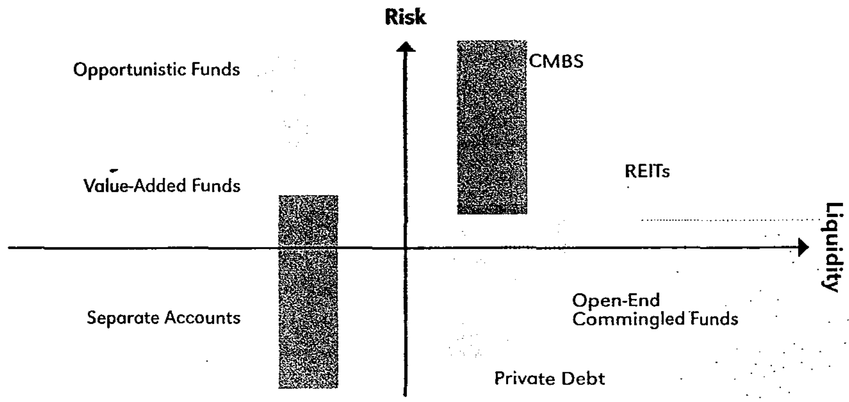
opportunities available to investors today. Exhibit 2 illustrates the approximate current value of each quadrant.

In each strategy the fundamental revenue source consists of leases paid by tenants who occupy commercial properties. This income is potentially augmented by the capital appreciation of the asset, realized at the time of sale. Private-equity investment involves the purchase and management of commercial buildings, including office buildings, industrial warehouses, multifamily apartment complexes, hotels and retail shopping centers. This investment may be made through open-end commingled funds and separate accounts. Public-equity investment involves the purchase of shares in real estate investment trusts (REITs) and real estate operating companies (REOCs), providing investors with exposure to real estate via publicly traded securities. Private-debt investment includes the origination and acquisition of senior debt (whole mortgages) on commercial properties. The public-debt market includes the origination and trading of commercial mortgage backed securities (CMBS).

The four sectors can be differentiated by their relative risk and liquidity profiles. Debt assets provide a senior claim on future rents at a specified rate and over a specified period. They sacrifice some potential return in favor of predictability. Equity investments, on the other hand, carry higher risk because the claim on future rents is subordinate to the debt position. The benefit of the equity position lies in an enhanced ability to control the property through active management and to benefit from the growth of future rents and from property appreciation. Private-equity real estate investors generally anticipate higher returns than do public-equity investors, reflecting the lower liquidity and higher risk of the private market. While REIT shares can be actively traded through an organized, efficient and transparent market where abundant information exists, private-equity transactions are conducted between individual buyers and sellers with less information.

The debt markets have evolved to provide an increasing number of sophisticated financial products to investors. Public-debt investing, predominantly in the form of CMBS, emerged as a strong global trend beginning in the early 1990s. The liquidity provided by trading CMBS in a public market, as well as the ability to securitize

**EXHIBIT 3: RISK AND LIQUIDITY ACROSS REAL ESTATE INVESTMENT VEHICLES**




*Source: ING Clarion Research & Investment Strategy*

large income streams and tranche loans into various risk profiles, helped make CMBS an increasingly attractive investment opportunity, although upheaval in the capital markets in 2008 and 2009 severely impacted the origination and values of CMBS. During this period private debt, which for many years was the primary vehicle for commercial debt investment, has taken on an increasingly prominent role. Exhibit 3 illustrates the relative risk and liquidity characteristics of some of the major types of commercial real estate investment vehicles. Using these vehicles, investors can craft portfolios based upon their needs for liquidity, risk and returns.

This chapter will focus mainly on investment strategies for private-equity real estate investment, as this approach has historically been a cornerstone of most institutional portfolios and we believe it provides a good foundation for understanding the other strategies.

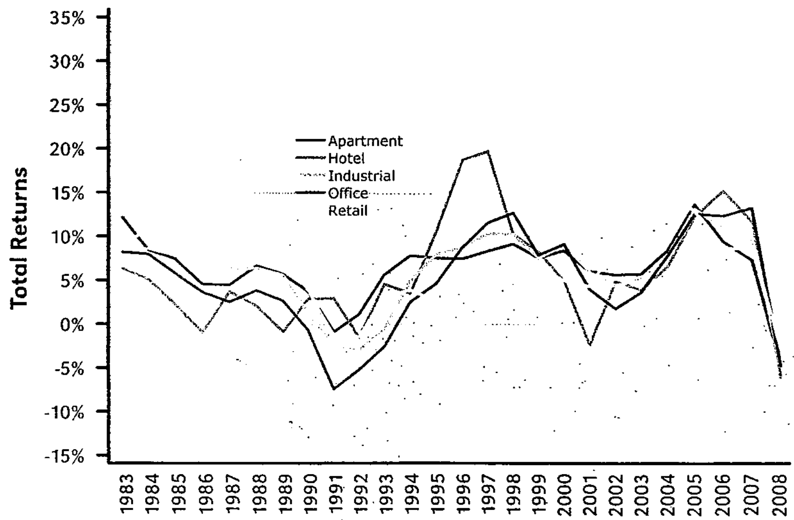
### Investing by Property Sector

Private-equity real estate investments are generally focused among the five main property sectors: office, industrial, multifamily, retail and hotel. Investment preferences may vary depending on current and forecast economic conditions, lease types, professional management requirements and other characteristics unique to each sector. For example, generally low vacancy rates in the multifamily sector are offset by the requirement for intensive, active management. Knowledge of the local market and management experience are thus particularly important in the multifamily sector to maximize returns and mitigate risks. The hotel sector has historically borne the most volatile returns; however, it is also typically the first sector to recover after an economic downturn, presenting the potential for high returns with careful market timing.[1]

In the US, institutional-quality real estate investments are tracked by the National Council of Real Estate Investment Fiduciaries (NCREIF). The NCREIF Property Index (NPI) is a good

[1] National Council of Real Estate Investment Fiduciaries, historic returns data, as of Q4 2008.

EXHIBIT 4: NCREIF PROPERTY INDEX ANNUAL TOTAL RETURN BY PROPERTY SECTOR




*Source: ING Clarion Research & Investment Strategy, NCREIF, as of December 31, 2008*

representation of investment performance for the five core property sectors (Exhibit 4).

**Office**

Office-sector properties are generally categorized based upon location and quality. Buildings may be located in Central Business Districts (CBDs) or suburbs. Buildings are also classified by general quality and size, ranging from highest-quality and generally large-scale Class A buildings to below-investment-grade Class C buildings; institutional investors tend to focus on only Class A or B buildings. So called "trophy" office buildings are generally found in supply-constrained markets such as Manhattan, Boston and San Francisco. Typically, trophy buildings are of the highest quality with notable architecture and outstanding locations.

The duration of office leases (typically five to 10 years) is longer than that of other property types and helps to mitigate the office sector's historic volatility.[2] It is generally understood that the complexity and size of many office projects contribute to long construction timelines. If economic conditions change during the construction period, new space may be delivered in a time of weak fundamentals. In addition to long construction timelines, CBD office properties are capital-intensive, requiring large financial outlays for purchase, renovations and tenant improvements.

**Industrial**

Industrial properties are generally categorized as warehouses, research and development (R&D) facilities, or flex space and manufacturing.[3] NCREIF returns for the industrial sector reveal less volatility than in the other property sectors,

[2] Wheaton, W. "The Cyclic Behavior of the National Office Market," *American Real Estate and Urban Economics Association Journal*, 1987.

[3] Manufacturing space tends to be a small focus for investors, as it typically is owned directly by end-users, not by investors.

suggesting that investment in this sector is a relatively defensive strategy.[4] The relatively short construction timeline, typically six to nine months, allows the sector to be much more responsive to changes in demand, and helps avoid significant overbuilding. Industrial properties usually require relatively modest capital expenditures for maintenance and tenant turnover. The triple-net lease structure common to the sector helps the owner mitigate many of the risks associated with rising expenses. However, industrial properties tend to have lower total values and constructing a sizable and diversified industrial portfolio one property at a time may be difficult. Portfolio acquisitions have thus been more common in the industrial sector than in other sectors.

### Apartment or Multifamily

Multifamily properties are generally defined as having five or more dwelling units. There are three main types of multifamily product: garden-style (mostly one-story apartments), low-rise and high-rise. Typically, institutional-grade apartments consist of at least 20 or more units. The apartment sector is similar to the industrial sector in that both feature relatively short construction periods and may be developed in phases, making them more responsive to changes in demand. Apartments typically have the lowest vacancy rates of any sector — rarely above 10 percent even in economic recessions.[5]

### Retail

The retail sector is comprised of five main formats: neighborhood retail, community centers, regional centers, super-regional centers and single-tenant stores. Like the hotel and apartment sectors, retail properties require a high degree of active management. Location, convenience, accessibility and tenant mix are generally considered to be among the key criteria for successful retail investments. Retail leases tend to range from three to five years for small tenants and 10 to 15 years for large anchor tenants. Leases, particularly for anchor tenants, may include a base payment plus a percentage of sales. The cost of upgrading and renovating retail properties can be significantly higher than in other sectors, and upgrades may be required on a more regular basis to maintain functional utility. Overall, returns on retail real estate investments tend to closely track the economy — both local and national. Income and population density are generally considered to be key drivers of local retail demand.

### Hotel

We believe that hotel investment is best understood as both a real estate sector and an operating business. Generally characterized as a non-core asset class, the hotel sector exhibits the highest volatility of the five main property types according to NCREIF returns. This volatility is due primarily to extremely short effective lease terms, as hotel rooms are essentially leased on a daily basis and hotel owners or operators are able to adjust their rates quickly. As a result, hotel revenue has been largely correlated with gross domestic product (GDP). Hotel demand is derived from business convention and leisure travelers. Although hotels are the most volatile of the five sectors, they can offer the highest return potential during an economic recovery.[6]

### Mixed-Use

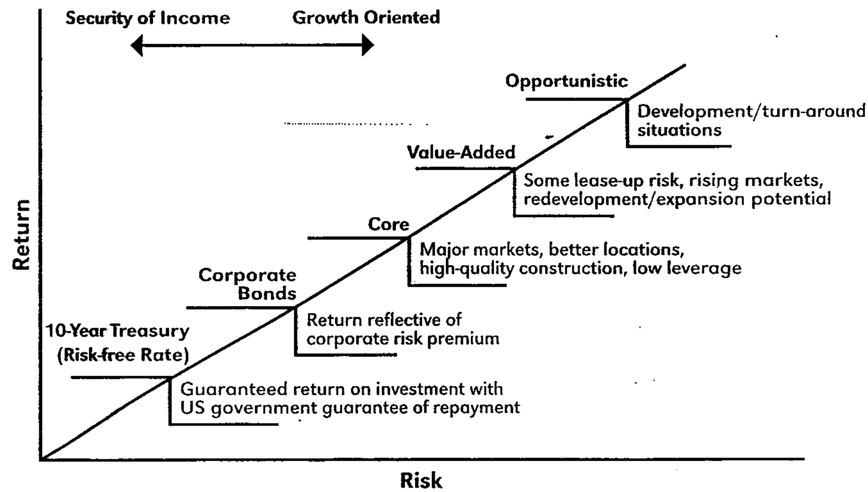
Mixed-use, as the name implies, is a combination of uses (sectors) within one property. Mixed-use properties may include multiple uses in a single structure (vertical mixed use) or multiple uses within close proximity of one another in an integrated development (horizontal mixed

[4] National Council of Real Estate Investment Fiduciaries, historic returns data, as of Q4 2008.

[5] According to Torto Wheaton Research, the national vacancy rate has not topped 7.2 percent since 1994. Torto Wheaton Research, Outlook XL Online, Apartment Sum of Markets, as of Q1 2009.

[6] National Council of Real Estate Investment Fiduciaries, historic returns data, as of Q1 2009.

EXHIBIT 5: REAL ESTATE INVESTMENT STRATEGIES




*Source: ING Clarion Research & Investment Strategy*

use). This development style has become much more popular in recent years due to the renewed popularity of urban living, urban redevelopment and brownfields renewal efforts, which all aim to maximize development potential and density on increasingly expensive land. This product type often combines high-density residential, office and retail uses in one site. Integrating the various components of a mixed-use project demands a higher attention to design than do the other property sectors, generally increasing costs. These types of projects have historically been large in scale and located in central urban areas, but their increasing popularity has resulted in a growing number of smaller projects in suburban locations as well.

## Investing by Style

A range of investment styles allows real estate investors to pick a preferred level of risk. There are three main investment styles: core, value-added and opportunistic. These strategies offer a range of options along the risk-return spectrum, as indicated in Exhibit 5.

### Core Strategy

Core real estate accounts for more than half of all institutional real estate commitments.[7] It is generally understood to represent a long-term, low-risk/low-return strategy. Investors are typically attracted to core real estate because of its high yield, stable bond-like characteristics, its value in diversification and its inflation-hedging benefits. Investment in core real estate focuses on the acquisition of existing, well-leased and high-quality properties in established markets. Investments are focused in the four primary property sectors: office, industrial, retail and multifamily. Core properties typically demonstrate stable and predictable income flows from strong credit tenants. A high proportion of the anticipated total return in this strategy is generated from current income and cash flow. Property appreciation plays a lesser role, but the stability of

[7] *Real Capital Analytics*, Q1 2009.

the properties helps to provide more predictability of future property values and potential purchasers. Low-to-moderate leverage is used for asset acquisition, further minimizing risk. The target total returns are in the 7 to 10 percent range.

### Value-Added Strategy

The value-added strategy spans the spectrum from less-risky core-plus approaches style to higher-risk and more opportunistic plays. In its most fundamental form, value-added real estate investment involves buying a property, improving it in some way and selling it at an opportune time for a capital gain. Capital appreciation normally comprises a significant portion of the investment's total return. Properties with management problems or operational issues, or properties that require physical improvements, are prime candidates for this strategy. Significant expertise in re-tenanting and rehabilitating properties is required for successful execution. The value-added strategy normally employs 40 to 70 percent leverage and the target total returns are in the 13 to 17 percent range.

### Opportunistic Strategy

Opportunistic investing represents the highest-risk/highest-return strategy available in private-equity real estate. In the past, most institutional investors had minimal exposure to opportunistic investments in their portfolios. However, the search for higher returns in recent years spurred growing interest in this strategy. Opportunistic investments are made based on their return potential, with little or no consideration given to diversification, either by property type or by geographic region. Opportunity funds target distressed assets (property or debt), development projects and emerging markets. In general these investments are more complicated and risky than their less-opportunistic counterparts and could involve non-traditional or specialized property types, complex financing and or financial restructuring, highly-leveraged transactions, ground-up development and international markets. Opportunistic investing often uses high leverage (above 70 percent) and targets total returns over 20 percent, with a limited income component.

## Investing by Phase

Investors can also choose to invest in a specific stage of the property life cycle. The three basic stages are development, stabilization and repositioning (or redevelopment). This approach allows the investor an additional opportunity to balance risk and reward.

### Development

Development is typically part of an opportunistic strategy. In a market with significant barriers to entry, development can be justified if existing properties regularly sell at a premium to their development cost. Markets with high barriers to entry are often characterized by strong demand fundamentals (high occupancies and rents) and low capitalization rates (cap rates).[8] In markets characterized by low barriers to entry, new properties run the risk of being priced close to or at their development cost, which generally does not justify the risk premium for development.

### Stabilization

The stabilization phase occurs when the construction phase is finished and leases are in place to reach a target occupancy level. Stabilized properties are the focus of a majority of investment activity because the risks of owning stabilized buildings are partly mitigated by a clear record of operating income and expenses, which allows for a more accurate projection of future income. Stabilized properties generally demand a higher price (a lower cap rate) than development or redevelopment properties, given the lower risk. As such, stabilized properties also typically generate lower total returns. Stabilized investments

[8] The capitalization rate is one year's expected net operating income divided by the current property market value.

| EXHIBIT 6: NCREIF HISTORIC RETURN CORRELATIONS | | |
|---|---|---|
| NCREIF HISTORIC RETURN CORRELATION | 10-YEAR | 30-YEAR |
| S&P 500 | 0.49 | 0.16 |
| Barclays Capital Aggregate Bond Index | -0.23 | -0.14 |

*Source: ING Clarion Research & Investment Strategy, S&P, Barclays Capital, as of December 31, 2008*

are usually preferred by large institutional investors. A standard strategy is to hold for income returns and sell when the spread between return on investment and the cap rate is the greatest.

**Repositioning or Redevelopment**

This is also known as the value-added phase. When stabilized properties command large price premiums in markets with high barriers to entry, repositioning or redevelopment is a logical investment strategy. Poorly-managed or cash-strapped properties with high potential are typical targets in repositioning or redevelopment strategies.

### Asset Allocation

According to modern portfolio theory, the inclusion of low-correlation or negatively-correlated assets in a portfolio can minimize overall portfolio risk. Real estate as an asset class exhibits low-to-negative correlation with equities and bonds (Exhibit 6). We believe that an allocation of between 10 and 20 percent of real estate assets in a mixed-asset portfolio can potentially enhance investment returns and reduce portfolio risks over a long-term investment horizon.[9]

Real estate is typically underweighted in mixed-asset portfolios.[10] We believe that there are several reasons for this. First, real estate is perceived to be risky. Much of this perception stems from the severe real estate downturn of the early 1990s. Second, many investors feel that real estate is relatively illiquid and inaccessible to small investors. As we have seen above, this situation has been changing with the proliferation of real estate investment options.

### US Real Estate Market Outlook

We believe that the US commercial real estate market is facing its most serious challenge since the last major real estate downturn in the early 1990s. Market participants are noting that a confluence of factors — the weakening economy, the financial crisis, a lack of attractive financing and massive de-leveraging — is putting considerable upward pressure on cap rates and downward pressure on market fundamentals. To reflect market reality, real estate asset managers have begun to record capital value losses for their existing portfolios. The most recent NCREIF returns (for Q1 2009) illustrate that significant negative appreciation has not been offset by strong positive income return.[11] Rent growth has begun to slow, while vacancy rates are rising across all property sectors.

This chapter has defined the primary types of real estate investment, investment options, styles and strategies that can be used by foreign investors investing in the US commercial real estate market. As the financial crisis pushes the

[9] Bellman, T., Paradinas, M., Taylor, S. "The Case for Real Estate: Asset Class Performance at the Cusp of Recession," *ING Real Estate Internal Publication*, 2008.

[10] Sitvitanides, P., "Why Invest in Real Estate: An Asset Allocation Perspective," *Real Estate Issues*, 1997.

[11] National Council of Real Estate Investment Fiduciaries, historic returns data, as of Q1 2009.

US economy into a severe recession, there are increasingly more attractive opportunities for core, value-added and opportunistic investments in the 2009–2011 time-frame, particularly for investors just entering the market. The distress in financial institutions and the collapse of CMBS securitization have resulted in a significant dislocation in the commercial real estate capital markets. Ongoing balance sheet de-leveraging is causing distressed asset sales. Many investors who financed their investments in the 2005–2007 time period using aggressive underwriting assumptions or short-term debt are having difficulty finding attractive terms for refinancing and are forced to sell at a discount. These circumstances are beginning to create opportunities for investors, as highly-desirable assets are becoming available at more attractive pricing than has been seen in many years.

**David J. Lynn, PhD, Managing Director and Head of Research and Investment Strategy Group, ING Clarion Partners**

David Lynn is an institutional real estate investor, strategist and developer with extensive experience in national and international markets. At ING Clarion Partners, he is managing director and head of ING Clarion Partners Research and Investment Strategy Group. In this capacity, he defines firm-wide and business-unit-specific investment strategy for the private equity, public debt and public equity (REITs) platforms.

**Tim Wang, PhD, Vice President, ING Clarion Partners**

Tim Wang, PhD, is a vice president of ING Clarion Partners and senior investment strategist at the firm's US Research and Investment Strategy Group. He is responsible for macroeconomic analysis, portfolio strategies, market forecast and client services.

**Bohdy Hedgcock, Associate, ING Clarion Partners**

Bohdy Hedgcock is an associate in the Research & Investment Strategy Group of ING Clarion Partners. He provides both bottom-up market analysis and top-down analysis of economic, demographic and market trends. He holds a BA from Southwestern University and a Master's in urban planning from the University of Colorado.

# Chapter 2

## THE BROKER/INVESTMENT ADVISOR: A WIDE RANGE OF OPTIONS FOR INTERNATIONAL CAPITAL

Jacques N. Gordon, LaSalle Investment Management, and Noble Carpenter, Jones Lang LaSalle

International investors face a wide range of options when they consider making investments in US real estate. It should come as no surprise that the world's foremost consumer society also offers the widest range of investment products and sources of financial advice when it comes to investing in commercial real estate. The credit crisis that started in 2007 and accelerated in 2008 will change many of the risk-return attributes of US real estate as re-pricing and de-leveraging occur. However, the basic principles involved in setting up an investment program and identifying a trusted service provider have not changed in any substantial way over the last 10 years. One of the first things foreign financial managers should do before building a US real estate portfolio is to clarify their objectives and how they want to achieve them. A short checklist of investment criteria is shown in Exhibit 1.

A professional investment advisor plays a critical role in helping shape an investment program to meet the specific goals of an international investor. Clarification of these goals will narrow the wide range of investment alternatives — which includes listed real estate securities, commingled funds,

**EXHIBIT 1: INVESTMENT CRITERIA**

- Time horizon
- Return expectations
- Target size of allocation to US real estate
- Tolerance for different types of risk (specific risk, duration risk, market risk, *etc.*)
- Degree of discretion given to advisor
- Liquidity requirements
- Investment style: income, growth, opportunistic
- Downside protection *versus* upside potential
- Use of leverage
- Tax position in the US, ability to use tax losses
- Currency and cash management
- Reporting requirements

**EXHIBIT 2: THE REAL ESTATE CAPITAL MARKET MATRIX**

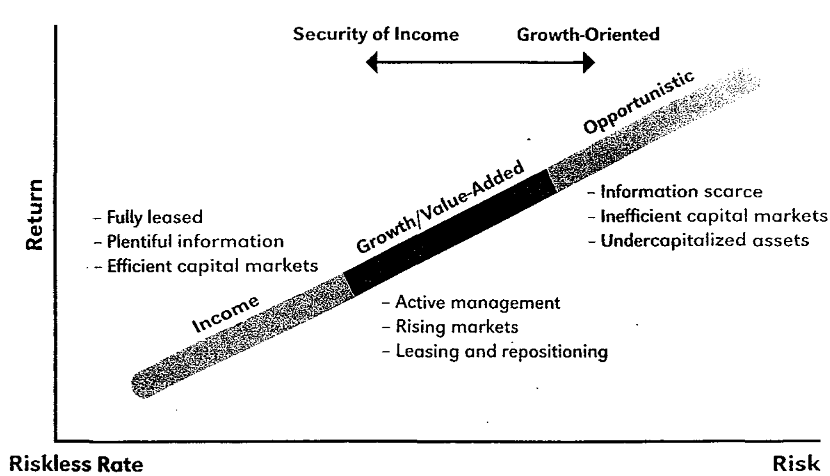
| | EQUITY | DEBT |
|---|---|---|
| **PRIVATE DIRECT MARKET** | Direct property investments<br>Partnerships and joint ventures | Mortgage and syndicated loans<br>Mezzanine debt |
| **PRIVATE INDIRECT MARKET** | Opportunity funds<br>Private placements<br>Commingled funds | High-yield CMBS<br>Mezzanine debt funds<br>Distressed debt funds |
| **PUBLIC MARKET** | Real estate investment trusts (REITs)<br>Real estate operating companies (REOCs) | Investment grade CMBS<br>REIT debt |

*Source: LaSalle Investment Management Research*

mortgages and direct-equity investments. The matrix shown in Exhibit 2 illustrates the six broad options available to investors in the US capital markets. Each cell in this matrix offers different combinations of financial and legal characteristics, which can be matched against the investment criteria checklist.

Each part of the capital market matrix ultimately derives its financial performance from commercial real estate, yet the financial and legal structure of each investment vehicle creates very different risk-reward combinations. Exhibit 3 illustrates some of the tradeoffs associated with the various cells in the matrix. The different combinations of liquidity, governance, control, diversification and financial reporting offered by each option compel investors to clearly define their own investment objectives, tolerance for risk, reporting requirements and investment horizon.

**EXHIBIT 3: INVESTMENT STYLES – A RISK/RETURN APPROACH**



For instance, a direct-equity investing program maximizes an investor's control over each asset, but diversification and liquidity objectives become harder to achieve. When investors allocate less than $25 million to US real estate, real estate securities (REITs and CMBS) offer much greater diversification and higher levels of liquidity than direct investing. For investors allocating between $25 million and $100 million to the US, commingled funds (open- and closed-end) also offer a reasonable degree of diversification while giving investors the chance to seek more customized strategies than those broadly available to the investing public. These funds do not offer nearly the same degree of liquidity as publicly traded securities but many long-term investors are more than happy to give up some liquidity to avoid the price volatility found in the public markets.

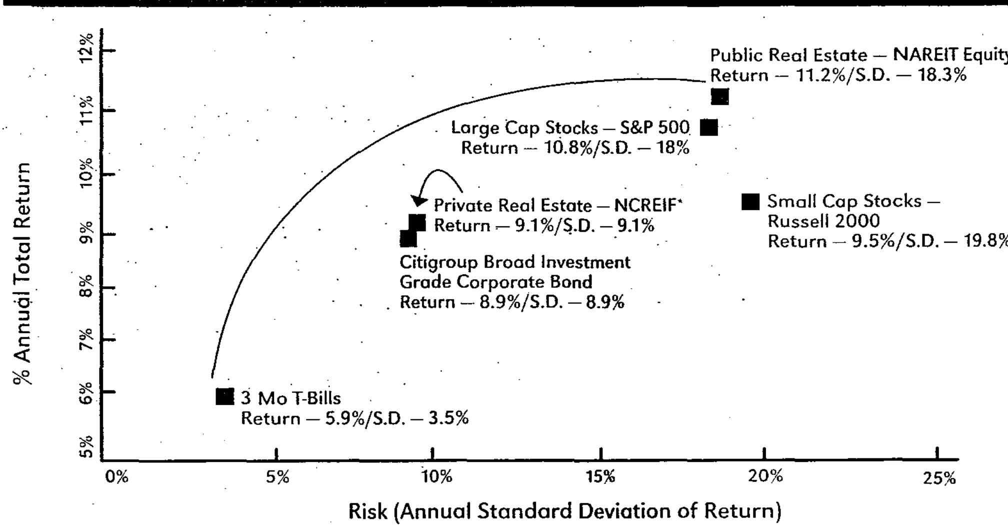
Exhibit 4 illustrates that investors will also need to consider how to combine real estate with other asset classes in building their US portfolios. Geographic and property-type diversification are important considerations for long-term investors.

Some international investors will be looking at US real estate as an extension of their domestic real estate portfolio. Others will be looking at US real estate within the context of a broader US portfolio of stocks and bonds. Still others will simply be seeking a safe harbor in dollar-denominated hard assets. Whatever the context, a professional investment advisor should be prepared to guide an investor toward appropriate levels of diversification at the portfolio level, in addition to offering asset-specific or security-specific guidance. A diversified portfolio will reduce the risks associated with specific properties or markets.

## Choosing an Advisor

Many intermediaries, advisors and consultants specialize in one or more of the different investment vehicles described in the real estate capital market matrix. However, no investment professional can cover every cell in this matrix with equal levels of expertise. Moreover, geographic and property-type specialties are very common. As a result, an international investor faces a seemingly overwhelming number of

**EXHIBIT 4: OPTIMAL PORTFOLIO – RETURN VS. RISK 1980 TO 2008**




**Unleveraged, fully-occupied real estate. Risk measured by doubling volatility of NOI to correct for appraisal smoothing.*
*Source: NAREIT, NCREIF, S&P 500, Russell 2000, Citigroup, Federal Reserve, Moody's Economy.com*

| EXHIBIT 5: SOURCES OF INVESTMENT ADVICE FOR PRIVATE EQUITY | | | |
|---|---|---|---|
| **PROFESSIONAL** | **SERVICE PROVIDED** | **WHO PAYS?** | **PAID HOW?** |
| **BROKER** | Access to asset for sale<br>Seller's agent<br>Buyer's agent | <br>Seller<br>Buyer | <br>Commission<br>Commission |
| **CONSULTANT** | Asset allocation and manager screening | Investor | Time and expenses of retainer |
| **INVESTMENT MANAGER** | Portfolio management and strategy | Investor | Performance & AUM |
| **ASSET MANAGER** | Asset-specific budgets, reporting | Fund manager | Performance & AUM |
| **PROPERTY MANAGER** | Leasing and rent collection | Fund manager | Commissions & AUM |

*Note: AUM = Assets Under Management*

choices when first investigating the options. How should an investor begin? As in any country, it is important to understand the players and define their roles. Exhibit 5 lists the major sources of investment services found in the US for direct investing in equity real estate.

Although each of these functions is quite distinct, in some cases they can be carried out by the same individual or firm. Many US real estate service providers have different divisions capable of carrying out each of these important functions. When embarking on any investment program, a foreign investor should clarify which functions are to be carried out by whom. In the world of direct investing, all five of these functions are required for the smooth operation of a large portfolio. In some cases, investors may reserve some of the strategic, portfolio-level decisions for themselves. In others, the investment manager takes on all responsibility for the portfolio mix. Finally, the amount and the type of leverage the investor decides to use in financing its real estate portfolio is often carried out by a "debt advisor." This service is either retained directly by the owner or through the owner's investment manager, and is an important component of an investor's portfolio strategy.

Providers involved in the securities and debt sectors have similar roles and functions, although the names may differ. For instance, a placement agent for debt capital is often called a correspondent or mortgage banker while the asset manager is called a servicer. There is no property management function in a debt context — unless there is a default, which then becomes the responsibility of a special servicer. In a REIT, the asset and property managers are typically all employees of the trust while the strategic investment management functions are carried out by its CEO, CFO and board of directors. By contrast, a direct-investment program may hire third parties to execute various leasing or management functions.

Brokers in both the private market and publicly-traded vehicles are required to have the proper licenses and both are regulated. However, the brokerage function for the real estate securities market, unlike the private market, requires the services of a market-maker. Although commission structures are vastly different between the public and private markets, the brokerage function is very much the same — to act as an intermediary between buyers and sellers.

## Advisors, Consultants and Money Managers

The title "advisor" can legitimately be applied to any of the functions listed in Exhibit 5 but there are several important distinctions to keep in mind. First, investors must understand exactly who is paying for the service and advice being offered. A buyer needs to be aware that seller's agents, sell-side securities analysts and rating agencies who opine on the merits of a specific asset or the credit-worthiness of mortgage-backed securities or unsecured REIT debt are all paid by the owner or the entity raising capital. The current turmoil in the capital markets is due in part to inadequate regulation and oversight of the rating agencies and sell-side analysts. The rating agencies' reputations have been badly damaged, and a new system needs to be created to bring back a securitized debt market. By the same token, seller's agents know that their reputations for truthfulness and full disclosure are among their most valuable assets. Nevertheless, the fact that owners or issuers of debt are paying for these services should raise a *caveat emptor* signal to any investor.

Asset allocation consultants, appraisers and market research firms all charge investors for their services, much like any other professional firm. For large assignments, these firms are often on a retainer, which gives clients access to the top consultants on an as-needed basis. These consulting firms are usually unwilling to put their fees at risk, pending the outcome of their advice.

The services rendered by investment managers and buy-side brokers are quite distinct, although both are paid by the investor. Investment managers act as fiduciaries or money managers and remain involved with the investment through the entire holding period. They expect that a portion of their fee will be tied to the performance of the assets in their custody. The key distinction here is that the investment manager provides reporting and asset-management services once the transaction is completed, while the buy-side broker typically focuses on the transaction itself. The investment manager is typically paid for performance over the holding period of the asset, while buy-side brokers act as placement agents and are paid for identifying, tying up and assisting in the closing of targeted assets. In the equity markets, seller's agents rarely share their commissions with buy-side brokers, so the services of the buy-side broker must be paid by the investor. However, most cross-border investors do not have their own asset-management staff and require ongoing investment management services. As a result, buy-side brokerage is much less common in the US for equity investors than it is in Europe or Asia.

## Principals and Agents

Another important distinction is the difference between an "agent," who represents a transacting party or investor, and a principal, who is a party to the transaction or investment. Principals either put their own assets at risk alongside the investor or put a significant portion of their fee at risk until the financial outcome of the investment is known. Principals are commonly thought to have a closer alignment of interest with investors than are agents. But agents also have their reputations and repeat business to think about when conducting business on behalf of an international investor.

The notion of a principal also acting as an investment manager for an international investor raises the question of whether the principal has the same time horizon and risk tolerance as the investor. Going back to the investment criteria in Exhibit 1 (page 11), investors should not be surprised to find several differences between their own investment objectives and those of their co-investment partners. Rarely are two sources of capital exactly alike when it comes to risk-taking and risk-avoidance. Nevertheless, the co-investment model, in conjunction with a back-ended performance fee, remain powerful tools available to international investors to ensure the alignment of their own and their investment manager's financial interests. Investors should remember that the amount of the co-investment is less important than the relative significance of the co-investment amount to the sponsor of the investment vehicle.

### Discretionary *versus* Non-Discretionary Investment Programs

As suggested in the checklist from Exhibit 1, the degree of discretion granted to an investment manager is a key choice to be made by the investor early in the process. At one extreme, an investor may prefer that all investment decisions be approved by the capital source, while at the other the investment manager may make all the decisions, subject to previously-agreed parameters. To an investor, the advantage of retaining discretion is control over the investment program and the outcome. The disadvantages include a reduction in nimbleness and a steep learning curve on each transaction that can slow down decision-making. Moreover, the accountability for success and failure is less clear than in a discretionary program.

### In-House *versus* Out-Source

A growing group of money managers are now based in more than one country. Some of these institutions face the choice of doing their US investment activity themselves or outsourcing it to a specialist. Several investment management firms specialize by working exclusively with capital from one country and putting it to work in US real estate on behalf of that country's investors. Others have established a global platform and are capable of working with both assets and capital sources across multiple countries. Offshore institutions without US staff always face the decision of whether to put some of their own people into the market to help with investment activities. The more elaborate approach of building an entire organization capable of buying, managing and reporting on US-based assets is an expensive option. Most non-US-based sources of capital elect to outsource some portion of their investment activities, depending on their own capabilities and needs.

### Due Diligence

Ultimately, the international investor seeking real estate advice in the US should apply the same tests they would use with their domestic advisors and investment managers. An acronym, STEP (Skills, Trust, Experience and Performance), reminds an investor to evaluate an advisor from four important perspectives.

#### Skills

The right blend of skills — strategy, execution and reporting — must match the nature of the assignment. A regional or property-type specialist will have valuable insights within that range of expertise, but may be less versatile for a broad assignment. Excellent communication and listening skills are also critical. International investors should look for advisors who are adept at dealing with offshore clients and who can demonstrate a commitment to high levels of service across time zones and across cultures. A tendency to offer advice first and to listen second (if ever) marks some US-based advisors as more interested in their own welfare than that of the client.

#### Trust

A deep and enduring level of trust must be established between investor and advisor. Trust can only be built up over time, of course. Nevertheless, evidence of high ethical standards should be examined, such as the way an advisor handles confidential information and treats its employees. Lawyers and accountants who regularly deal with the advisor can provide important insights — especially to an international investor unaccustomed to American business practices.

#### Experience

The credentials of the individuals handling the account must be examined, especially with respect to their experience with cross-border transactions and foreign entities doing business in the US.

References from recent clients should be sought. Turnover statistics among senior staff can also be requested. Offshore investors should keep in mind that American professionals do change employers more frequently than their European or Asian counterparts. A cumulative turnover rate of less than 10 percent over several years demonstrates a reasonable level of stability in the US.

#### Performance

Ultimately, an investor needs to know that the advisor knows how to make money in commercial real estate. Three- and five-year track records of each candidate's performance should be sought. This performance should be compared to a relevant investable universe with a similar risk-return profile. Investors should confirm that the individuals who created this performance are still with the firm. Performance of discretionary assets is more telling than the performance of non-discretionary assets but both are important, especially to an investor seeking a non-discretionary relationship. Investors should also make sure that the statement of this performance is compliant with the international guidelines laid down by the International Accounting Standards Board and described in the International Financial Reporting Standards (IFRS).

#### Financial Health

In the aftermath of the credit crisis it has become imperative to ascertain the financial soundness of any investment advisor. The near-collapse of many major banks and financial institutions has taken its toll on a wide variety of real estate service providers. An investor should inquire about the exposure of any firm to balance sheet problems or debt-refinancing problems that could lead to bankruptcy or to the departure of key individuals.

### A Local Business Goes Global

It is often said that the key to success in cross-border real estate investing is the ability to think globally but to act locally. An advisor who cannot excel at both will not serve the interests of a cross-border client. International investors almost always have different needs than domestic sources of capital. To be successful, the investment advisor must have the ability to understand the transaction from the perspective of the cross-border investor. An advisor who has learned how to "walk in the moccasins" of a cross-border investor, will be best prepared to give truly useful advice.

In the aftermath of the worst financial crisis since the 1930s, the landscape of US real estate is changing rapidly. Values are falling, mortgages are harder to obtain, and leveraged owners are under pressure to de-leverage their properties or face foreclosure. In the capital constrained environment of 2009–2012, foreign investors will play an important role by providing needed capital and earning very healthy returns.

In hindsight, investing in the US when debt capital was plentiful and cheap and real estate fundamentals were at or near their cyclical peak turned out to be a risky strategy. The risks and opportunities of investing in a down-cycle are quite different. Yet the principles of developing an investment program with clear objectives and identifying a trusted advisor are not only still relevant, they may hold the key to unlocking value in a market coping with massive turmoil.

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Jacques Gordon is the global strategist for LaSalle Investment Management (LIM), a global real estate money manager and a wholly-owned subsidiary of the Jones Lang LaSalle Group. He currently serves on the board of directors of AFIRE. Dr. Gordon received his PhD from MIT, a Master's from the London School of Economics and an undergraduate degree from the University of Pennsylvania.

**Noble Carpenter, International Director, Jones Lang LaSalle**
Noble Carpenter is based in New York where he runs Jones Lang LaSalle's loan sale and restructuring business within the real estate investment banking group. He is a member of the Global Capital Markets Board and a senior client relationship manager. Mr. Carpenter has over 20 years of experience, including debt placement and note sales, partnership and debt restructuring, joint venture placements, investment sales, office leasing and portfolio management. He received his MBA from Northwestern University Kellogg School of Management and his BA from Colby College.

# Chapter 3

## THE ATTORNEY/TAX ADVISOR

J. Greer Cummings, Jr. and John R. Haynes, Bradley Arant Boult Cummings LLP

Attorneys and tax advisors play significant roles in real estate transactions in the US. The purpose of this chapter is to describe the extent of those roles and to alert foreign investors to the various factors they should take into account when selecting attorneys and tax advisors. Those roles and factors may vary in proportion to the size and complexity of the transaction, although the principal selection factors should remain constant.

### Role of the Attorney

The involvement of the attorney can be as extensive as the transaction demands and or as the client may request. The role may vary depending upon whether the attorney is representing a seller, purchaser, developer, borrower, lender, equity investor or other participant, and it may involve some or all of the following aspects of the transaction:

- preparation and negotiation of letters of intent, confidentiality agreements and commission agreements; advising the client on related liability issues, especially binding obligations which may result from letters of intent or commission obligations which may result from events other than actual consummation of the transaction
- preparation and negotiation of purchase and sale agreements and related documents; advising the client on necessary, advisable, standard or customary contractual provisions, on liability issues, particularly those arising out of representations and warranties, their survival beyond the closing of the transaction and limitations on amounts owed or recoverable for related breaches, and on termination issues, particularly those arising out of unsatisfactory due diligence and changed circumstances (such as casualty, condemnation and loss of income)
- conducting due-diligence activity such as review of title, surveys, environmental reports, structural reports, leases, service or operating agreements, local zoning ordinances and codes, parking ratios and certificates of occupancy
- planning and structuring acquisition, disposition or development
- forming the investment entity, including negotiation and documentation of such elements as limited partnership agreements, limited liability company operating agreements and joint-venture agreements through which the essential contractual, economic, operational and other arrangements are to be effected
- negotiation and documenting any financing for the investment and assisting in the satisfaction of loan closing conditions

- conducting and or participating in the closing of the transaction, including confirmation that all contractual obligations are satisfied
- advising the client on compliance with applicable reporting requirements, including the International Investment and Trade in Services Survey Act and, when appropriate, the Agricultural Foreign Investment Disclosure Act
- assisting with operational matters following acquisition such as preparation of office, retail and ground leases, property management and leasing agreements, and negotiating the terms thereof.

It is very important for the legal and tax advisors to cooperate with one another in the development and implementation of the tax structure for an investment, the selection of an appropriate entity, and the inclusion of appropriate tax provisions in such entity's organizational documents. In many instances, entities are formed under the laws of the state of Delaware, and limited partnerships and limited liability companies are favored forms, owing to their flexibility.

## Selection of the Attorney

Many factors enter into the selection of legal advisors. These include the following.

### Experience in Handling Transactions of Like Kind

An attorney with significant experience in similar transactions will often be able to facilitate the consummation of the transaction. An inexperienced attorney may cause delays, increased costs and expenses and, in extreme cases, failure of the deal. Some attorneys operate more like counselors, with a style and attitude that enable them to push a deal along, while others serve more as legal technicians who can provide valuable advice but may not necessarily be right for a given transaction.

### Reputation of the Firm and Its Attorneys

Foreign investors have many sources for investigating the reputation of potential US legal advisors, ranging from publications such as *Chambers USA* and *The Best Lawyers in America*, to referrals from other foreign investors, accounting firms, brokers and business consultants.

### Experience in Representation of Foreign Investors, Including the Ability to Communicate, Understand and Appreciate the Client's Organization, Culture and Style

Foreign investment in US real estate generally entails extensive tax planning and analysis, in terms of both US treatment and treatment in the investor's home country. US legal advisors should be able to provide or coordinate others' provision of these services. Moreover, it is important for the US legal advisor to be able to communicate easily with and understand the business culture and style of the foreign investor so that the latter can be reflected in the negotiation and structuring of the transaction.

### Ability to Understand the Client's Business and Legal Objectives, to Find Solutions to Problems and Issues, and to Accomplish Goals

This factor surfaces in many aspects of a US real estate transaction. For example, the limited partnership agreement and the limited liability company operating agreement will provide much of the contractual basis for an investment transaction. The US legal advisor should be able to negotiate and draft such agreements in a manner that will effectively and successfully attain the economic and operational results desired.

### Sufficiency, Availability and Efficiency of Attorneys Staffing the Transaction

The staffing decision is often dictated by the size and complexity of the transaction. Firms may staff transactions with large or small teams, or with senior or less-experienced attorneys under senior attorney direction. The foreign investor should make known its desires at the outset, so that there is no misunderstanding.

### Fees and Expenses

Throughout the selection process, cost considerations should be borne in mind. While US law firms are often reluctant to agree to a fixed fee for a particular engagement, especially when the time required to complete it cannot be reasonably estimated at the beginning, there may be occasions when a fixed fee arrangement, or a combination of a fixed fee and hourly rates arrangement, can be structured.

A foreign investor that may engage in transactions in more than one state might choose a firm with offices in appropriate locations. Alternatively, a US law firm without multiple offices could retain local counsel in different states as needed. A third possibility would be to select a firm in each state as needed.

Foreign investors might also consider the issue of conflicts of interest. A law firm selected may have represented, or may be currently representing, another party to a transaction in another matter. For real estate transactions, depending on the facts, circumstances and nature of the conflict in question, such conflicts may sometimes be waived with the consent of the parties involved after full disclosure.

## Role of the Tax Advisor

The services provided by a tax advisor include tax planning, tax compliance and the resolution of tax controversies. Planning includes advice regarding the selection of the appropriate entity or entities to hold the investment, developing the capital structure to minimize US and foreign taxes, and structuring the most tax-efficient disposition of investments. Tax advisors provide advice in preparing models or projections of the financial performance of investments at acquisition and at disposition of the investment. Compliance services include preparation of US tax returns for the entity or entities that hold the investment and for the individual partners, shareholders or members. The tax advisor will also provide advice regarding US withholding requirements, including that required by the Foreign Investment in Real Property Tax Act (FIRPTA). Finally, tax advisors provide services in resolving tax controversies, including audits, administrative appeals and litigation in the courts.

## Selection of the Tax Advisor

Factors similar to those relevant to the selection of attorneys apply to the selection of tax advisors. Tax advisors in the US usually are attorneys and accountants. If the foreign investor has tax advisors (attorneys and or accountants) in its home country that have sufficient US tax experience, the foreign investor may prefer to retain them as tax advisors. Alternatively, the foreign investor may seek tax advice through the tax attorneys in its US law firm or tax accountants in the US office of its accounting firm or a US accounting firm. Many US law firms, particularly larger ones, have both experienced real estate attorneys and experienced tax attorneys. In the US, tax attorneys and tax accountants provide similar and sometimes overlapping services. It is customary for tax accountants to provide compliance services, including return preparation and withholding compliance. Both tax attorneys and tax accountants provide advice regarding the structuring of the acquisition, ownership and disposition of investments, entity selection and the resolution of controversies at administrative levels. In the case of a controversy that requires litigation, tax attorneys are required. It is not uncommon to have attorneys and accountants sharing responsibility as tax advisors.

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John Haynes is a partner in the Nashville office of Bradley Arant Boult Cummings LLP. His primary practice involves the development, acquisition, financing, leasing and sale of institutional quality investment properties, with a special emphasis on serving German clients. Mr. Haynes is included in national publications of best or leading lawyers for real estate.

# Chapter 4

## JOINT VENTURES, PART I: CONSIDERATIONS ENTERING INTO A JOINT VENTURE

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Some people half-jokingly define a joint venture as a relationship that begins with one party having all the money and the other all the expertise and ends with the parties switching places. Too often this has been a sadly accurate description of the fate of the financial partner in a real estate joint venture, and a number of broadly accepted principles have evolved to maximize the possibility of success in establishing a joint venture. This article will review the key issues in forming and structuring a joint venture, focusing on the financial aspects and how the partners can work together to deal with difficult times once the venture has been formed.

Choosing the correct partner for an indirect investment is as essential to a successful relationship as choosing a promising asset, especially in a market fraught with economic risk. While there may be many domestic real estate companies with sterling track records and expertise in the desired asset class and location, it is essential that the domestic real estate company and the foreign partner have respect for one another and have clearly articulated a shared view of the key elements of the relationship and the investment strategy. Direct and clear discussions of the level of financial risk each is willing to bear in the transaction and of the parties' expectations for returns from the investment is essential at the inception.

The domestic real estate company and the foreign partner must have principals who can work well together — the "chemistry" should fit. If the investment performs as expected, the relationship may never be tested. However, mutual respect, trust and an ability to work together through unexpected challenges may become essential to successfully overcome problems that arise during the life of an investment.

In the past economic cycle, some domestic companies had high yield expectations that were achievable only with relatively high leverage and over a short time horizon (one to four years). In the short term such strategies may no longer be viable. Domestic real estate companies will likely be conservative in the current environment as they will not want to dispose of their assets in a down market. The current credit market will force these companies to maintain leverage levels that are conservative by any measure. A foreign investor must be sure that there is an agreed time horizon for the investment and an exit mechanism that assures a sale of the property or another disposition method to realize the full value of the investor's interest in the asset. Enough flexibility must be built into the arrangement to permit the venture, or a partner that wants to stay in the deal, to avoid a sale. Where the domestic real estate company has publicly-traded securities, converting the ownership interest in a joint venture into readily marketable securities is one option that should be explored. The joint-venture agreement should state any limitations on acceptable leverage either as an absolute dollar amount or as a percentage of fair market value.

### What the Partners Bring to the Venture

Most investors require their partners to invest a certain amount, on a *pari passu* basis, in their joint ventures. This investment is usually not less than 5 percent of the capitalization of the joint venture. The amount should be significant for the domestic real estate company so they truly share the financial risks of the investment and should substantially exceed the amount of any fees paid to the domestic partner. Often domestic real estate companies are required to subordinate return on their capital investment to a minimum return to the investor. This forces the partner, in effect, to underwrite its own projections. Since the minimum return threshold is always substantially below the expected return on the investment, subordination of the domestic partner's return to a minimum threshold return should not be very difficult to achieve. However, to the extent the domestic partner is required to mitigate the risks of the investment through subordination of its returns from the venture, it will usually insist on increasing its promoted or carried interests in the venture.

Domestic partners are often permitted to charge market fees for services rendered to the joint venture for property and asset management. This includes fees for special tenant services, construction services and often leasing commissions. Acquisition and disposition fees are often part of the structure as well, especially if no outside broker is involved. Reimbursement for the costs of operating and managing the assets are of course paid by the venture, but limiting these costs to exclude general office expenses and senior management salaries can be important. The profit component of fees to the domestic partner may also be subordinated to the minimum return threshold anticipated for the investment, but this may be difficult to quantify and implement.

The organizational ability of the domestic partner to report on the performance of the asset on at least a quarterly basis with annual audited financials can be critically important in selecting a partner. The domestic partner must be able to develop clear and timely operation and leasing plans for the asset and be willing to meet and fully review these plans periodically with the investor. Long-term business plans with a three- to five-year horizon are often sought by investors so they can plan well in advance for their own cash-flow needs. The extent to which investors have approval rights over business plans and budgets are hotly negotiated.

The ability and experience of the domestic partner to assist in US tax reporting requirements for the foreign investor and flexibility in structuring the relationship to address particular tax and accounting needs of the investor should be considered in the selection process. For some foreign investors, utilization of a domestically-controlled real estate investment company may be most tax advantaged, while for others a traditional joint venture is best.

In joint ventures involving several investors with a domestic partner, no issue is more highly negotiated than the investors' controls over major decisions, ranging from those relating to sales and financings to approval of annual business and leasing plans and even individual decisions on significant leasing or other commitments. Often investors have as much difficulty deciding how far they will permit other investors to be involved in decisions as they do ceding authority to the domestic partner. It is our opinion and experience that once the foreign investor has become comfortable with his domestic "expert" partner, the investor should give the domestic partner a "long leash" so that the joint venture can act expeditiously and stay competitive in a fast-moving business environment. In real estate "timing, timing, timing" is as important as "location, location, location." Once a property gets the image in the marketplace that "the ownership" is not decisive, especially in leasing and brokerage, that ownership can lose attractive opportunities.

Reviewing the financial statements of the domestic partner is often part of an investor's due diligence activity. Where the domestic partner is a public entity, its filings with the Securities and Exchange Commission provide a good and readily available resource. Such statements can also provide a perspective on the domestic company's view of its business operations because management is required to analyze its operations and state its goals for the coming years. For private individuals or companies, confidential disclosures of financial statements can be arranged where necessary.

Finding a good partner is often more difficult than finding an attractive property. In every market the brokerage community is active in bringing properties to the attention of direct investors. With no equivalent for the joint-venture marketplace investors often turn to the biggest names with the best reputations. The few advisors who are active in putting together joint ventures generally deal with only the larger assets and very few focus on the international investment market. With only a few exceptions, the Wall Street firms that would have the resources to be active in this market do not focus on putting together joint ventures. Often foreign investors turn to local experts with cultural familiarity and international reputations.

## Capital Contributions

As mentioned above, domestic and foreign partners are commonly required to share in making capital contributions to a venture. The domestic partner may fulfill this obligation by contributing assets to the venture, in which case, it is important for the investor to determine that the initial valuation of the contributed assets is fair. This often involves obtaining third party appraisals. Usually the contributor is also required to make the full panoply of representations and warranties, and to satisfy closing conditions such as obtaining estoppel certificates.

There are significant tax advantages for domestic partners to contribute assets rather than cash to a venture. The principal benefit is the non-recognition of taxable gain at the time of the contribution. But these tax benefits are often lost on a subsequent sale of assets by the joint venture, which can distort the alignment of the parties' financial interests. A domestic partner that contributed assets will pick up the built-in gain (the taxable gain that was not recognized at the time of the formation of the venture) upon the sale of the joint venture's assets. This can cause the domestic partner to resist a sale, even if the timing is appropriate, in order to avoid a substantial tax payment. The joint-venture agreement must deal with this issue by specially allocating the built-in gain on contributed assets and securing the right of the investor to force a sale, perhaps after an agreed upon lock-in period, while protecting the domestic partner through a right of first offer or refusal.

Capital contributions may be staged over a period of time. The obligation may be evidenced by capital-contribution notes and secured by any asset, including letters of credit, especially if the amount of and schedule for the contributions is fixed. Since priority returns usually accrue on capital investments, the domestic partners are not eager to accept capital before it is needed by the joint venture, even though there is a risk that future scheduled capital contributions may not be made when required. Thus, the deferral of capital contributions that are not needed at the inception of a deal is a common element of many agreements.

### Unscheduled Capital Calls

Of course, there is a possibility in any joint venture that future unanticipated capital calls may be required to meet the needs of the business. These usually break down into two categories — necessary capital and discretionary capital. Most investors insist that necessary capital may be called by any venturer to pay real estate insurance, premium mortgage payment (including balloon payments at maturity) and the like. Discretionary capital calls for expansions or renovations that enhance the asset often require the approval of all venturers and can be made only if alternative funding mechanisms are not available.

Failure to meet a capital contribution whether planned, initial or deferred, is dealt with through a number of devices ranging from treating contributions made by the non-defaulting partner as senior default loans bearing a high rate of interest to giving non-defaulting partners the right to squeeze down the interest of the defaulting partners with a penalty formula. These devices can be expanded to include a loss of voting rights by the defaulting partner for significant and prolonged defaults in meeting capital obligations. The non-defaulting partner may also receive the right to terminate existing management contracts with the domestic partner and the exclusive right to sell the assets where a partner is not meeting its capital commitments. Usually extremely harsh remedies are provided for investors who fail to meet capital calls, since the major contribution to the business by the investor is the promised capital contributions.

It is common for the capital invested by the venturers to receive a priority return calculated as a percentage of the amount invested from operating proceeds. Some partnerships are structured so that the domestic partner has an increasing interest in distributions after the priority returns have been achieved, which may increase, in any number of steps, as the return levels grow. This increasing participation is commonly called the "promoted interest." The prior returns to the investor are usually cumulative in nature and annually compounding, so that shortfalls in one year are captured in subsequent years, with interest, so that the investors achieve their expected return before the developer's profit is paid. Some of a developer's promoted interest may be held back in a secured account until the venture is finally unwound to assure the investors' minimum return on the transaction. The local partner's capital is often treated on a *pari passu* basis with the investors' capital but, as described above, it is sometimes subordinated.

With increasing frequency, investors are insisting on true IRR priority returns on their invested capital before the domestic partner receives any promoted interest. Of course, these issues become more complex if multiple assets are included in a single venture. Because gains on one project may be offset by losses in another, the parties must decide whether the entire portfolio is treated as one unified investment or whether each asset is treated separately. This treatment will profoundly affect the timing of distributions to the partners and may cause varied results from the investment.

Taxes may arise for partners even when cash is not being distributed. Extensive negotiations of complex tax distribution provisions are often required to be sure that tax obligations of the partners are met from the venture's cash flow on a priority basis. The tax exposure of the parties in each jurisdiction should be fully analyzed so that these payments can be structured into the agreement. Foreign partners should be careful to ensure that all tax payments in the US and in their home jurisdiction are covered by distributions, to the extent possible, as priority payments.

## Challenges to the Venture's Performance

Even with a venture that has been thoughtfully structured, the market conditions in 2009 pose significant risks to all real estate projects. In the current climate, many real estate projects are suffering in performance and are in danger of defaulting under their financing. As market demand for space decreases, rents are under downward pressure, space may be very difficult to market and leasing costs are increasing. Because of the prevalence of relatively short-term (three to five year) interest-only loans in the last economic cycle, even projects that are fully leased and otherwise performing are facing the maturity of their financing without the ability to refinance. Cash-flow troubles caused by the recent economic downturn can lead to a venture's falling behind on its loan payments. Uncertain real estate valuations can cause a failure to satisfy the economic tests (such as loan-to-value ratios) on which maturity-date extension options are conditioned. Additionally, other ongoing financial covenants, such as net-worth tests, debt-service coverage ratios or loan-to-cost tests on construction deals, may trigger a lender's right to trap the property's cash flow or to call a default.

The same cash-flow issues can also result in the venture having difficulty covering expenses after debt service. If the venture does not have the operating capital to fund capital expenditures such as tenant improvement allowances or necessary renovations, or even to pay its day-to-day operating expenses, the joint-venture agreement may require the partners to fund additional capital contributions to cover such shortfalls. Failure to make these contributions can trigger the harsh remedies previously discussed, including treating contributions made by the non-defaulting partner as high-interest default loans, a squeeze-down of the defaulting partner's interests and loss of voting rights. Unless an obligation to fund these shortfalls is built into the joint venture, the partners will need to work together to find a mutually agreeable solution to these problems.

It is critically important that the investor maintains open lines of communication with the domestic partner so that these types of stresses on the venture do not come as a surprise. With open lines of communication, the partners can work together creatively to find solutions to these difficult situations. The foreign investor may be able to realize substantial benefits by providing the additional capital needed to partially or fully de-lever the property or to cover cash shortfalls to pay property expenses. Such cash infusion can avoid foreclosure and preserve the venture's (and the partners') equity in the asset. Of course, if the investor member is not required to provide this capital under the terms of the joint-venture agreement, it should be able to enhance its business deal *vis-a-vis* the domestic partner.

Often the venture must enter into a "workout" with its lender to negotiate such matters as extension of the maturity date of its loan or relief from financial covenants that have become onerous. This relief may be granted by the lender in return for a partial pay-down of principal and other concessions. The investor and its domestic partner must be on the same page before such negotiations start. Before any conversations with the lender take place, they must decide between themselves who will take the lead in the negotiations and what workout terms to propose to the lender. In certain cases, it may be advantageous for the foreign investor to handle such negotiations, since the foreign investor may know the lender's personnel better than does the domestic partner. This would be especially true if the lender knows that it is dealing directly with the "money" partner who has the ability to infuse equity into the venture and de-lever the troubled asset. The partner handling the negotiation must regularly update the other partner on the status of the talks and seek the other partner's buy-in to any negotiated terms.

An alternative to a direct pay-down of the venture's debt is for the foreign investor to purchase a subordinate participation interest in the venture's existing loan in connection with a loan workout. This will serve to reduce the lender's exposure to the troubled asset and, if structured correctly, eliminate any default arising from failure to meet a debt-service coverage test. This structure provides a benefit both to the developer partner — who is now free to operate the property and earn its return clear of any default, cash trap or looming maturity under the debt — to the investor partner — who now has a marketable debt participation interest that can enhance its overall investment in the property.

As such a structure entails a built-in conflict of interest, it must be carefully discussed and agreed upon in advance between the domestic partner and the foreign investor. The investor member is acting as both lender to the venture and venture partner, which may give it the ability to gain (through "back-door" means) approval rights over venture activity that it otherwise would not have under the joint-venture agreement. Moreover, any attempt by the foreign partner to purchase an interest in the debt without the domestic partner's approval may trigger fiduciary liabilities under the joint-venture agreement. The parties should therefore fully discuss the extent of the investor partner's rights toward the venture as a lender and should consider restricting the investor partner's ability to exercise remedies against the developer partner, especially under any loan guarantees given by the developer partner. The parties should also enter into an agreement providing that any decisions of the venture relating to the investor partner's enforcement of the loan against the venture will be made solely by the domestic partner. Additionally, the domestic partner should insist on reviewing and approving any agreement between the investor and the existing lender.

In return for any outlay of capital, whether via a direct contribution or a purchase of a subordinate debt piece, the foreign investor may be able to negotiate for itself certain modifications to its business deal with respect to the venture. The previous business cycle was marked by an increase in the negotiating leverage of domestic partners, leading to many ventures in which the domestic partner had little equity in the deal (relying on its promoted interest for payment) and a great deal of control over day-to-day operations and material decisions affecting the venture. The foreign investor's decision to ride to the rescue of the venture can be an opportunity to swing the balance of power in the venture back toward a middle ground.

Economic rights a foreign investor may seek in such a situation include an increase in its IRR priority returns and or subordinating (or further subordinating) a certain amount of the domestic partner's capital to the foreign investor's returns. The foreign investor should strongly consider requiring the domestic partner to contribute a *pro rata* share of equity, or reducing the domestic partner's promoted interest, in order to maintain the alignment of the domestic and foreign partners' economic interests.

The foreign investor can also use the need for additional capital to shore up its non-economic rights in the venture, to further assure that the domestic partner is making the correct business decisions in an unstable economy. Some decisions over which the investor can seek a greater level of approval include future capital expenditures, budget approvals, financing (including any workout or refinancing decisions) and leasing parameters. Increasing control and oversight over the venture's activities going forward will mitigate the risk of the venture slipping again into a distressed state. The foreign investor will not want to be involved in every decision, however, so while its major-decision and other control rights may be tightened, it should still use a relatively "long leash" with respect to decision-making.

The foreign partner can also take steps to ensure that the partner it has so carefully selected is the actual day-to-day decision maker at the property. For example, it can tighten liquidity requirements by restricting a domestic partner's right to sell or syndicate its equity in the venture. It can also require that if key individuals vital to the management of the property are removed or replaced it would have the right to force a disposition of the assets of the joint venture.

If the investor partner believes that the venture's troubles are not due solely to the economy but rather that its domestic partner has been incompetently managing the asset and if it believes the asset itself still has value, it can insist on changes to the management arrangements. If the joint-venture agreement does not otherwise provide default remedies, the investor partner can insist that in return for its capital contribution the domestic partner must step down as the managing partner of the venture. Under these circumstances the investor would bring in an experienced third-party manager to run the asset, and the domestic partner would lose its management rights while still retaining any equity position in the venture.

A joint venture with a domestic real estate company can provide access to excellent opportunities that are otherwise unavailable. It can allow a foreign investor to leverage its management time by using local talents. It can diversify risk and be an important part of an overall strategy for investment in US real estate. It should not, however, be viewed as an entirely passive investment. A close working relationship usually develops early in a successful partnership. In the joint-venture environment, it is particularly important to structure the relationship in this fashion, providing for the domestic partner both positive incentives, such as promoted interests, and negative incentives based on shared financial risks and subordination of the profits to the investor's minimum returns. It is important for the principals to discuss difficult subjects, no matter how uncomfortable the discussion, at the inception of the transaction and throughout the term of the venture, and to agree on major issues, such as financing terms, holding period and general investment goals. With a frank understanding of the key elements of the investment and the relationship, a joint-venture strategy can be a great vehicle to provide solid returns to a foreign investor.

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# Chapter 5

## JOINT VENTURES, PART II: STRUCTURES AND TERMS

Noel W. Nellis, Orrick, Herrington & Sutcliffe LLP

Real estate joint ventures typically take either the form of a general partnership or a limited liability company, principally due to tax advantages that these entities provide. Although a limited partnership may also be used for a joint venture, it is less common for various reasons. For example, a limited partnership is more restrictive concerning the rights of limited partners to exercise control over management. In the last two decades limited liability companies have become the preferred form of entity for joint ventures, due to the assured availability of limited liability for the members and the flexibility available to them in matters such as management and operation. For purposes of this discussion, it will be assumed that the joint-venture entity is either a general partnership or a limited liability company. In addition, it is also assumed that the venture will be between an "investor" (the party supplying all or a majority of the capital) and a "promoter" or "developer" (the party with the expertise to acquire or develop and to operate the project).

### Management of the Venture

Except as may otherwise be provided in the joint-venture agreement, all of the partners or members, as a matter of law, generally have equal voting rights in the management of the venture business. Consequently, it is important to define the parties' management rights in the joint-venture agreement. Notwithstanding that each of the parties has a strong interest in retaining management rights, practicality demands that one of the venturers be principally responsible for the day-to-day management of the venture since it is not feasible to require that every management decision be approved by all venturers.

#### Decision Making by the Venturers — Major Decisions

A common, and preferred, arrangement in joint-venture agreements is to specify the "major decisions" that will require the approval of all venturers. The managing venturer is then left free to act on other matters. The list of major decisions requiring the approval of all venturers will depend on whether the venture is to be formed before or after the development phase of a project. As a practical matter, it is impossible to foresee all of the possible problems that might arise for the project and, if the joint venture is operating well, the parties will probably resolve issues without resorting to the terms of the joint-venture agreement. Nevertheless, for purposes of negotiating the agreement, the following are major decisions which typically require the approval of all venturers:

- sale of the venture property or acquisition of any additional real property
- financing or refinancing of the project or the venture or otherwise borrowing money on behalf of the venture
- approval of leases or material modifications in already-approved leases (a common approach to lease approvals is to give the managing venturer authority to enter into leases within prescribed leasing guidelines)
- capital improvements or other capital expenditures relating to the project (it is common for the managing venturer to seek authority to make capital expenditures up to a certain amount without the approval of the other venturer(s))
- approval of operating budgets
- approval of insurance and settlement of insurance and condemnation claims
- hiring or retention of key project personnel and professional advisors such as auditors and lawyers
- instituting material legal actions
- determination or adjustment of depreciation and accounting methods, or other decisions affecting state or federal income taxes
- determining whether distributions are to be made to the venturers, to the extent not otherwise covered in the agreement.

If the joint venture involves a development project there may be additional decisions that should be considered as major decisions, such as:

- approval of the development plan and material changes to it
- approval of construction-related and long-term financing for the project (to the extent not included in the development plan)
- approval of construction contracts and architectural agreements (to the extent not included in the development plan).

## Procedure for Making Decisions

Venture agreements typically provide that when decisions require approval of all venturers, voting rights are shared equally among the parties. Even where the economic interests in a venture are disproportionate (such as in a 60 percent – 40 percent split between two parties) it would generally be unworkable for the majority partner to be able to exercise total control on all major decisions. In contrast, in joint ventures with three or more parties it is common to provide that a specified percentage of the total interest controls. In any case, provision needs to be made for deadlock, which is typically handled through the buy-sell mechanism discussed on page 35.

Once the parties have agreed on the voting percentages, they should consider the system to ensure that approvals are properly obtained. The simplest approach is to allow the managing venturer to carry on the business and affairs of the venture, subject to approval only where it is required.

Some investors are not comfortable with such an arrangement because there is no built-in procedure for questioning the manager, forcing decisions or checking decisions made by the managing venturer. In the event of a dispute over a management decision the investor may find itself with no means to call a meeting of the venturers, and the managing venturer may continue to act in disregard of the investor but within its authority. To avoid such problems it is common to provide for a management committee. Any venture with three or more parties should use a management committee.

When a management committee is used, the joint-venture agreement should specify the procedures for calling meetings. In addition, the individuals authorized to act for each venturer should be named (subject to change upon reasonable notice). It is also desirable to provide for alternative management committee members for each venturer.

Whether or not a management committee is used in the venture agreement it is important that the agreement specify the individuals who are authorized to act on behalf of the venturers. From the point of view of the managing venturer and usually also of the investor venturer, it is desirable that the agreement require each venturer to respond to requests for decisions within a prescribed period of time (*e.g.*, 10 days) and provide that failure to respond within such time period will be deemed approval of the proposal submitted to the venturer.

**Furnishing Information to the Venturers**

In the case of the investor venturer who is not going to be running the day-to-day operations of the company, controls over major management decisions alone may not be sufficient. The investor should also have the express right to receive complete information about management activities and to review operations and activities of the managing venturer. Accordingly, the agreement should specify the managing venturer's obligations concerning such matters as monthly or quarterly reports, the preparation of an agenda for any management committee meetings, the preparation of a budget, annual audits, financial statements and other accounting matters, and the preparation of tax returns. In addition, it should specify the location of the venture books and provide for access by all venturers.

**Compensation of the Managing Venturer; Contracts with Affiliated Parties**

The managing venturer is not typically paid a separate fee simply for managing the venture. If the managing venturer is performing functions equivalent to a property manager or is responsible for the development of a project, however, then a property management or development management fee is frequently agreed between the parties. In any event, it is customary to reimburse the managing venturer for its normal and usual expenses in operating and managing the project. If the managing venturer is also engaged in other activities and businesses it is common to exclude from reimbursement the managing venturer's central-office overhead expense and other general and administrative expenses such as wages and salaries of employees other than those devoting most or all of their time to the project.

There are often services required by a joint venture that can be provided by one of the venturers or by an affiliated entity. An example would be a development project where the managing venturer has the capability to provide development, construction-management or leasing services. To allow for such efficiencies, contracts with related parties should not necessarily be prohibited in the venture agreement. Indeed, a major advantage of doing business with some developers is the "full service" potential they offer to an investor. On the other hand, it is customary to require approval by all of the venturers of any contracts between the company and one of its venturers or an affiliate of a venturer.

**Appointment and Replacement of the Managing Venturer**

Disagreements can arise concerning the management of a joint venture, and it is desirable to prescribe a procedure for the termination and replacement of the managing venturer. Some investors insist upon the absolute right to terminate the managing venturer at any time. This would obviously be objectionable to the managing venturer, who may insist that any termination must be for "cause," such as failure by the manager to comply with the provisions of the venture agreement; failure to exercise the appropriate level of management skill; fraud, misrepresentation or breach of trust by the manager; or an instance of bankruptcy or insolvency on the part of the manager.

## Restrictions on Transfer

### Rationale for Restrictions

Restrictions on the transfer of joint-venture interests are common and, in fact, necessary for a variety of tax and business purposes. For example, venturers ordinarily want to ensure that they will be able to continue doing business with the partner with whom they originally made the deal and do not want to be forced to accept a new partner in place of the one with which they began the venture. Nevertheless, it is important that the joint-venture agreement contain realistic means for dissatisfied venturers to exit the venture. Although a totally satisfactory solution may not be possible, the parties should attempt to deal with the problem.

### Types of Restrictions

Restrictions on the transfer of joint-venture interests take many forms, but typically will include some form of general prohibition on the transfer of interests to third parties, often granting only a limited ability to make such transfer subject to a right of first refusal in favor of the non-assigning venturer(s). Restrictions on transfer usually also apply to the mortgages of a venture interest, and should limit the indirect transfer of interests as well (examples of indirect transfer include sale of a corporate partner's stock, merger and or consolidation). Indirect transfers, if not restricted, could effectively vitiate the agreement's limitations on transfer.

Some transfer restrictions may be effective only for a designated period of time, such as during construction, lease-up or start-up (prior to break-even) periods for a new commercial building, or during any period when the likelihood of a call for additional capital is high.

Some agreements also provide that even in the case of a transfer that is not prohibited, the transferee will not be permitted to participate in the management of the partnership without the consent of the other venturers. Such a provision is frequently suggested to cover the case of an heir succeeding to a deceased or disabled individual venturer.

### Permitted Transfers

Exceptions to the general restrictions on the transfer of joint-venture interests are commonly allowed for transfers to affiliates, among existing venturers and, in the case of individual partners, transfers to family members through *inter vivos* trusts or by devise or descent. In the case of transfers to trusts for the benefit of family members, it is advisable to require the transferor to retain effective legal control over the trust or to retain for the other venturers the right to approve the identity of the trustee or any substitute trustee.

### Death or Disability of a Venturer

When dealing with an individual as a venturer, provisions should be made for the event of his or her death or incapacity. The most common provision is that upon death, disability or dissolution of a venturer, the estate, conservator or liquidator becomes an inactive partner with no right to participate in management, but with continuing rights to receive any profits and, in some cases, the continuing obligation to bear losses and fund capital calls. In addition, the other venturers usually have the right to buy out the affected venturer's interests, with the purchase price most commonly determined by appraisal.

**Rights of First Refusal and First Offer**

The device that is most commonly used to permit transfers of venture interests to unrelated third parties is the right of first refusal or first offer. The parties to a joint-venture agreement need to be familiar with the variants of these provisions and with the issues they may present.

- Will the provision require a *bona fide* third-party offer to trigger the right of first refusal, or will a venturer desiring to sell its interest be allowed simply to state the terms on which it is willing to sell and expect the other venturers to accept or reject? A *bona fide* offer is usually required by most institutional investors so that they will be able to identify the proposed purchaser of the venture interest.
- The time periods specified in a first-refusal or first-offer provision should not be too long or they may "chill" or effectively prevent any sale to a third party.
- The first-refusal or first-offer provision should allow a reasonable period of time for the selling venturer to consummate a sale with a third party after the other venturer(s) have rejected the offer, after which period the rights of the non-transferring venturer(s) reapply.
- The joint-venture agreement should also clearly provide that the rights of first refusal or first offer apply to the interest of a subsequent venturer, including one who buys into the venture pursuant to the right-of-first-refusal process.

## Dispute Resolution (Use of Buy-Sell Provision)

**Nature of the Problem**

There may be times when the venturers cannot agree upon the resolution of a particular issue, minor or fundamental. Typically, investors will reserve the right to act in their own discretion in matters of fundamental importance to the venture, and they will usually be unwilling to refer such an issue to an arbitrator or other third party for a binding decision. In the case of relatively minor matters, however, or where third-party expertise is appropriate (such as appraisal of value), arbitration or appraisal procedures might be made part of the joint-venture agreement. Most investors will resist broad arbitration clauses, preferring to narrow the issues for which arbitration or appraisal can be used.

**Use of Buy-Sell Clauses**

It is common for joint-venture agreements to provide that where disagreement occurs on a fundamental issue and the parties cannot resolve the dispute, a "buy-sell" or "put-call" mechanism can be used to terminate the venture. Such a clause is usually thought of as the ultimate mechanism for resolving disputes that make continued operation of the venture difficult or impossible. Procedurally, the clause typically provides for one party to offer to buy out the other at a stated price based on the total value of the project (as estimated by the offering party). The other party then has the right to sell its interest to the offering party at a price equal to the seller's share of the project's total value, or to buy the offering party's interest at a price equal to the offering party's share of the project's total value. Alternatively (and less commonly), a buy-out clause may use a price to be set by appraisal or arbitration.

In some cases, one of the parties may be concerned about its ability to raise enough cash to buy out the offering venturer upon exercise of the buy-sell provision. Concern may arise, for example, about the ability of an offering venturer to "lowball" the price. Common solutions to this problem include:

- a waiting period before the buy-sell provision can be used (two years after completion of construction, for example)
- giving the non-exercising venturer a substantial period of time to respond to an offer
- allowing the non-exercising venturer to buy the offering venturer's interest on favorable deferred payment terms rather than for cash.

## Dissolution and Liquidation

A typical joint-venture agreement provides that termination or dissolution of the company can occur only with the approval of all the venturers or after some specified number of years. Moreover, venture agreements customarily prohibit any of the parties from petitioning to dissolve or partition the project. An exception is sometimes made, however, to give a non-defaulting venturer the right to dissolve the venture and buy out a defaulting venturer's interest, possibly at a discounted price. In any event, the joint-venture agreement should contain procedures governing the dissolution and liquidation of the company when dissolution or liquidation is permitted. Ordinarily, these procedures will be fairly straightforward, but the parties should be mindful of the following questions:

- Who will handle dissolution and who will manage the project during the dissolution period, particularly if there is ongoing construction?
- Will there be priority payments in liquidation? If so, they should be recited in the agreement.
- Will there be rights to repayment of the capital accounts or will allocations be made based on percentage interests? How will disparate capital accounts be treated, for example will a venturer with a negative capital account resulting from disproportionate allocations under the agreement be required to repay it in order to achieve "substantial economic effect" for tax purposes (see more below)?
- If there will be any assets of the venture that are not feasibly reducible to cash, should there be a procedure for the distribution of these in-kind assets?
- Who will retain the books and records from the venture, and what will be the right of the other venturer(s) to have access to such materials?

## Tax Issues Affecting Joint Ventures

A real estate joint venture is customarily structured as a partnership or limited liability company because of the advantageous tax treatment such entities enjoy, particularly with respect to real estate investments. Under federal and state tax laws, partnerships (and limited liability companies, which for tax purposes are treated the same as partnerships) are subject to unique tax treatment. Consequently, tax planning and advice are of critical importance in the drafting and negotiation of a joint-venture agreement. The agreement must maximize the tax benefits that flow from the ownership of real property, while at the same time ensuring that other provisions of the agreement do not inadvertently diminish or preclude the availability of such benefits.

The primary tax advantage of partnerships and limited liability companies is that they are not required to pay federal or state income taxes on the entity level. Instead, income and losses from the operation of the business flow through the entity to the individual partners or members. The income of a partnership or limited liability company is thus taxed only once, at the partner or member level. This differs from a corporation, which pays taxes on its earnings at the corporate level and then makes cash distributions to shareholders that are taxable on the shareholder level.

In addition, tax law provides partnerships significant flexibility in allocating the income and losses among the partners or members of the entity. A primary advantage of partnership tax treatment is the ability to pass through tax losses, such as depreciation deductions, to the individual partners or members. In addition, losses may be allocated disproportionately among the partners or members, if the allocations have "substantial economic effect."

Partnership taxation is one of the most complicated parts of the US tax system and an analysis of partnership tax issues is beyond the scope of this chapter. In order to take advantage of the benefits of partnership taxation, the venturers and their tax advisors will need to understand and evaluate various provisions governing the allocation of income and losses and the distributions of cash from the operation of the venture. For example, a venturer's ability to deduct losses from the operation of the venture will depend on its tax basis and will be limited to the amount that the venturer is "at risk" with respect to venture activities at the end of the tax year. The determination of the amount at risk is a complicated subject involving, for example, the extent to which non-recourse financing increases a venturer's amount at risk. In short, readers need to be aware of the significant tax advantages available for real estate investments held in the partnership or limited-liability form, but they are cautioned to seek the advice of qualified tax or accounting counsel early in the process of considering and analyzing a proposed joint-venture investment. Readers are also reminded that general background information about US tax rules affecting equity investments in real estate is contained in Chapters 22 and 23 of the ***AFIRE*** *Guide to US Real Estate Investing.*

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# Chapter 6
## THE ACQUISITION PROCESS

Frederick Van Wagenen and Clay Adams, JAMESTOWN

In the commercial real estate acquisition process, one must begin with considerations of the asset type of real estate to be purchased and the return requirements — for both annual returns and total return. Equally important, of course, is the size of the investment — in both overall value and the amount of equity to be invested. Once these parameters have been set, next steps include market and property research, screening potential acquisition targets, determining the value of the property (underwriting), negotiating the purchase and performing the appropriate due diligence.

### Investment Strategy

The four basic categories of real estate investment are generally described as "opportunistic," "value-added," "core-plus" and "core". Opportunistic deals are the riskiest while core are the safest. The opportunistic play may require development, major re-tenanting or redevelopment. Value-added investing usually requires some re-tenanting due to near-term tenant rollover, and it may require expansion or renovation. Core-plus investments are fairly stable but will have some near-term rollover. Core investments typically involve Class A properties that have stable and secure cash flows. After determining the category of real estate investment, the location, property and tenant types need to be identified.

In addition to product category, a key strategic consideration is whether to invest through joint venture or direct investment. The advantages of direct investing include assuring control of the decision-making process in connection with property managers or leasing agents, financing decisions and exit timing. Joint ventures can provide advantages, including greater access to off-market deals, the ability to outsource many functions to the partner, and access to some best-in-class operators unwilling to take on fee-only assignments. Joint-venture investing can also offer a number of tax advantages.

### Geographical Preferences

Investors should narrow their geographic preferences by identifying specific cities and submarkets. Our experience has shown that properties seem to perform better when they are located in coastal cities with "24/7" activity, diverse economies, and long track records of both population growth and job growth. An additional requirement would be that the locations pose barriers to entry that constrain the market's supply of properties. Such constrained markets have a tendency toward appreciating rents and values. Suburban locations, by contrast, tend to show stagnated performance, although now some traditionally "suburban" locations have developed supply constraints as well and have in-fill characteristics. Markets with low barriers to entry are vulnerable to overdevelopment and oversupply. Another consideration is industry concentration. Manhattan (financial services), San Francisco and Silicon Valley (technology), Cambridge (biotechnology), Charlotte (banking) and Houston (energy) all represent markets where a fast-growing industry has driven real estate fundamentals and values rapidly higher in past cycles, only to leave the market exposed in a downturn. Such industry concentration can provide the long-term competitive advantages (the "clustering" phenomenon), but can affect exit timing and the speed of recovery.

Choosing a CBD (central business district) or suburban location partially depends on the property type chosen for the investment. The five major commercial property types are office, retail, apartment, industrial and lodging. Retail and apartment investments do not necessarily have to be located in large metropolitan cities, as their success depends more on neighborhood factors, such as population and job growth, demographics and constraints on future competition. Constraints on supply can arise from such factors as restrictive zoning, lack of potential development sites and geographic features (rivers, national parks, road systems, *etc.*). Industrial investments tend to perform better near intra- and interstate transportation hubs and ports. Office-building investments perform better in the aforementioned coastal, 24/7 urban submarkets where there are barriers to entry. Examples include midtown Manhattan. With rare exceptions, investments in markets without supply constraints are "timing plays" due to excessive supply and anemic long-term rent growth. One exception to this rule could be the introduction in growth areas of innovative new product, a "better mousetrap," that would make competing product obsolete in the eyes of some consumers. Examples of this sort of innovation include some of the new urbanist communities, such as Seaside or Celebration in Florida, or Glenwood Park in Atlanta, which create a sense of scarcity through their carefully planned identity.

### Tenancy

The type of tenancy acceptable to an investor depends largely on the investor's yield and appreciation objectives. Core and core-plus investments are generally leased to large-credit tenants on long-term leases which will offer safer returns. In consideration of these safer returns the pricing tends to be higher. Value-added and opportunistic plays typically have more tenant rollover. Since these are more management-intensive properties and carry more risks, the returns are substantially higher than on core and core-plus properties. Holding periods for the value-added and opportunistic plays generally range from three to five years in order to address the near term obstacles, while those periods for core-plus and core properties range from seven to 12 years and focus more on value creation through a long holding period.

### Research

Once the property type, geographical location and type of cash flow have been determined, the chore turns to research. This phase includes research of databases, city tours, consulting with third-party experts and networking. There are numerous data resources available, many of which are free. Periodicals, journals, newspapers and the Internet can provide excellent leads on acquisition candidates. Third-party sources include brokers, appraisers, and economic and demographic consultants. All of these sources are useful in identifying markets and specific properties.

It is far better to be proactive by doing your own research to determine the better markets, property types and tenants than to be reactionary, only responding to investment proposals submitted by real estate brokers. Working backward can lead to many opportunities for poor decisions as one works off of opportunities presented by others, *versus* leads generated consistent with a targeted approach.

Once the targeted cities are identified, the next step is to physically tour the area to get a feel for how the city works. Part of your tour should include meetings with appraisers, the Chamber of Commerce, the research departments of local newspapers, departments of economic development, local planning and zoning departments and, finally, brokers. With this research completed you will be equipped to target the better properties or respond to unsolicited opportunities presented by brokers who, of course, are valuable and excellent sources of investment opportunities, especially where the broker has an exclusive listing.

In utilizing the brokerage community, advise the leading players in each market of your investment objectives and criteria to attract information on properties that best fit your investment needs. An exclusive listing generally means that the owner is serious about selling the property.

Dealing directly with owners has its rewards, as properties can be uncovered that would not normally be available on the open market, and both buyer and seller can save on brokerage fees. The down side is that time and money may be wasted in pursuing an off-market deal should the owner have second thoughts. Determining if you have a "willing and ready" seller is a very important aspect of the acquisition process.

### Networking

Networking is extremely important in the acquisition process as it can generate additional leads and provide opportunities to preempt the brokerage process. Here too, it is better to be proactive than reactionary. Make use of as many personal contacts as possible, attend appropriate networking conferences, place cold calls to property owners, and make direct contact with brokers, developers, lenders, property tax consultants and other investors. Organizations like AFIRE, ICSC, NAIOP and ULI are made up of the "movers and shakers" of the real estate industry.

### Property Evaluation

Once a property has been targeted and you are satisfied with the market, the investment itself needs to be evaluated. Schedules and documents that should be obtained from the broker or owner include the rent roll, operating statements for the past three years, capital budgets for the current year, a description of the construction and improvements, and market information. The best sources for market information are appraisers and third-party consultants. The market study should determine the market rent for your subject property and the vacancy projected over the holding period. Investors may wish to target properties where the current contract rents are below market. Acquiring properties with above-market rents is an invitation for disaster (namely, a loss on sale). In evaluating the market, consider not only the existing supply of competing properties, but also those under construction and proposed.

Financing considerations are a key component of property evaluation. If an existing loan is being assumed, the length of that process can vary depending on whether the loan has been securitized or syndicated *versus* kept on the books of the lender. Assumption can take 45 to 120 days and will include a qualification process for the new borrower as well as a new appraisal. If a new loan is to be obtained, conversation should begin with lenders in tandem with the property-level analysis. The availability conditions and pricing of the financing (including reserve requirements) will have a significant impact on the financial model. The market of readily available financing in recent years has evolved in 2009 to a market with virtually no financing. Existing, transferable financing can be a key asset of a property.

### Valuation

With the rent roll and other research results in hand, the next step is to develop a *pro forma* statement of cash flow to cover the entire holding period — typically 10 years. Once the *pro forma* is developed the value of the investment can be determined by applying the appropriate capitalization and discount rates in a discounted cash-flow analysis. For properties where the cash flow is stabilized the value can be double-checked by capitalization of year-one NOI (net operating income) by the desired cap rate and comparison to comparable sales. The market approach to value can also be used to determine the value for such a stabilized property. For properties that have yet to stabilize or have fluctuating cash flows, the appropriate approach would be the discounted cash flow method which presents values of the annual cash flows and residual value generated by a sale at the end of the holding term. The cap-rate and present-value factors relate directly to one's yield requirements.

### Offer

The initial offer should be presented in the form of a non-binding letter of intent that outlines the basic terms of your offer. Next, negotiate the purchase and sale agreement (the contract) to tie down the details of the transaction. The contract should allow sufficient time to perform the due diligence and obtain financing. Due-diligence periods typically run from 30–45 days, while closing periods typically run 30–90 days from the effective date of the contract, often depending upon financing considerations. In performing the due diligence numerous aspects of the property need to be evaluated. These include market studies, both for the property and the local economy, engineering studies, environmental studies, credit analysis of the major tenants, title, an appraisal, review of leases, confirmation of *pro forma* assumptions, confirmation of governmental approvals (zoning, permits and availability of utilities) and confirmation that adequate insurance coverage is available.

By following the process described here and not wavering from your investment criteria, your efforts should produce reliable real estate investment opportunities. Do not compromise on your underwriting, even in a frothy market, as the real estate market rewards patience. Passing on a marginal opportunity can be your best investment.

### Frederick Van Wagenen, Director, JAMESTOWN

Frederick Van Wagenen received a BBA from the University of North Carolina-Chapel Hill in 1968 and an MBA in finance from Emory University in 1973. He served as regional real estate director for several major financial institutions and real estate companies. He later handled acquisitions for two other European real estate companies. Mr. Van Wagenen joined JAMESTOWN in 1996 as director of acquisitions. In 2002, he was named a director of JAMESTOWN.

### Clay Adams, Director of Acquisitions, JAMESTOWN

Clay Adams is a director of acquisitions at JAMESTOWN and serves as chief investment officer of the firm's opportunity funds. He previously served as director of acquisitions responsible for investments in the US and Canada at WestWind Capital Partners. Mr. Adams has worked in the real estate industry since 1992, and has extensive experience in real estate acquisitions, dispositions, asset management and financing. Mr. Adams earned an MBA at Emory University and a BA from Davidson College.

# Chapter 7

# PROPERTY DUE DILIGENCE

Wayne K. Fraser, Hudson Realty Advisors Limited

One of the most important aspects of the commercial real estate acquisition process is property due diligence. Once a suitable property has been identified and successfully taken under contract by way of a letter of intent or conditional purchase and sale agreement, a thorough due diligence is necessary. This process is typically accompanied by a refundable deposit and is undertaken over a 30- to 45-day period during which the prospective purchaser has the exclusive right to consider all aspects of the property and determine whether it wishes to proceed with the acquisition on the negotiated terms. Prior to the end of the due diligence period, the prospective purchaser may choose to do any of the following:

- In the event the prospective purchaser is satisfied with its findings from the due diligence process, it may elect to proceed with the purchase as negotiated by waiving the condition in the contract. A non-refundable deposit would typically be posted, the contract would become binding subject to a variety of closing conditions, and the sale would be expected to close.
- In the event the prospective purchaser is not satisfied with any aspect of the property resulting from its due diligence, it would have the right to terminate the conditional contract and obtain a refund of its initial deposit. There would be no further obligation between the parties and each would be responsible for its own costs resulting from the process.
- In the event the prospective purchaser is not satisfied with some aspect of the property, it could attempt to renegotiate the contract to alleviate its concerns and proceed on an altered basis. Such negotiation would typically take place prior to the end of the due diligence period and a new deal might be struck depending on the inclination of each party and the reasonableness of the prospective purchaser's request.

## Due Diligence Process

Typically, the prospective purchaser will draw upon its own staff as well as outside consultants and advisors to conduct its inquiries and investigation of the property. It is important that all participants in the process be well informed of the progress of other team members and give weight to their findings. Team meetings including all in-house staff and outside professionals are important. All results from the investigation need to be assembled and reviewed prior to the end of the due diligence period so that a well-reasoned decision can be made regarding the purchase of the property. The due diligence process would usually include consideration of five major areas.

**Legal Considerations**

The legal due diligence is undertaken by legal counsel and is intended to ensure that the prospective buyer understands all legal aspects of the property. Legal due diligence includes investigation or preparation of the following:

- the ownership interest being acquired
- title review including title documents, reports and opinions
- site plan
- review of surveys and any encroachments
- compliance with building code
- compliance with zoning
- list and ownership of chattels
- review of all encumbrances including
  - mortgages, charges and security interests
  - liens
  - easements and rights-of-way
  - development agreements
  - building restrictions
  - encroachment agreements
  - assignments of rents
  - capital leases
  - subsurface agreements
  - reciprocal agreements
- review of standard lease form
- review and summary of existing leases
- schedule of lease anomalies
- certificates of occupancy
- intellectual property
- licenses and regulatory matters
- review of active, pending or threatened litigation.

**Physical Considerations**

The physical due diligence is largely based on property inspections, a review of all design drawings and discussions with the building's operational staff. Structural and engineering reports are typically completed by third parties and should identify and comment on all physical aspects of the property, including actual or potential defects and the costs of repair or replacement. The process should encompass such items as:

- review of "as-built" plans and specifications
- structural review including curtain wall
- roof report
- engineering review including electrical, heating, ventilation and air conditioning
- elevator report
- assessment of life safety and fire protection
- confirmation of rentable-area calculations
- parking structures and pavement
- landscaping
- capital expenditure history
- building-code compliance.

**Environmental Considerations**

The environmental due diligence should be conducted by professional environmental consultants and should identify any environmental issues which may require remediation or which could result in potential liability for the new owner. The initial review is often referred to as a Phase I inspection, and may lead to more in-depth testing (Phase II) or, ultimately to remediation. The review should touch on such items as:

- historic use of the land
- review of permits, certificates, approvals and licenses issued or required by any government authority
- presence of any asbestos containing material (ACM)
- prior or current use of pesticides and herbicides
- existence of urea formaldehyde foam insulation (UFFI)
- existence of underground storage tanks (UST)

- assessment of indoor air quality
- details of any spills or other environmental incidents
- uses of ground water or surface water in the area
- waste discharge and sewer by-law compliance
- details of any PCBs in active use
- details of historic or past non-compliance
- copies of all policies, practices, procedures and systems in place.

**Financial Considerations**

The financial due diligence program ensures that the prospective purchaser has an accurate understanding of the financial performance of the property in the past, and it typically predicts likely future financial performance. This work is normally completed by the prospective purchaser and its financial advisors and might include consideration of the following:

- accuracy of accounting systems and records
- historic income statements and balance sheets (three to five years)
- historic capital expenditures and recoveries
- historic leasing expenditures
- rent roll
- current-year budget including leasing and capital programs
- list of all liabilities
- details of current debt
- historic assessment and tax notices
- tenant pre-bills and tenant reimbursements
- parking operations and history
- accounts receivable and payable
- historic tax returns
- comparison of lease summaries to rent roll and *pro forma* projections
- signed offers to lease
- security deposits, prepaid rents and letters of credit
- tenant abatements
- tenant sales.

After consideration of these items, assumptions can be made regarding the future. Revenue, expense and cash flow projections will assist in establishing estimates of value, pricing tactics and expected investment returns.

**Operational Considerations**

Another important aspect of the due diligence program is a review of all operational and property management matters relating to the property and its tenants. The purchaser's operations managers or its third-party property managers should conduct this review, including such matters as:

- current property-management team
- current operations guidelines
- tenant correspondence files
- tenant disputes and complaints
- current operating costs
- parking operations
- energy audit
- capital expenditures in progress
- tenant improvements in progress
- deferred maintenance
- capital requirements
- contracts and service agreements
- property and liability insurance
- employee handbooks, building policies
- collective agreements
- worker's compensation claims
- building security.

## Asset Plan

Purchasers may benefit from developing an asset plan for the property being acquired. This plan can be an extension of the due diligence program and should consider all practical and strategic aspects of the transfer, operation and ownership of the property. It is important to set out a game plan for all aspects of the investment and to establish measurable targets.

Every prospective purchaser of property will address the due diligence process in its own way. Experience, expediency and cost may all affect the process, but a professional and comprehensive program should help to minimize surprises after the purchase has closed.

**Wayne K. Fraser, President and Principal, Hudson Realty Advisors Limited, Toronto, Canada**

Wayne Fraser is president and principal of Hudson Realty Advisors Limited, which provides property advisory services and investment support to international investors working in Canada, and to domestic investors seeking capital or opportunities internationally. Mr. Fraser's 35-year career in Canadian and international property markets includes a long-term senior management rôle with one of Canada's largest and most respected commercial real estate owners and managers. Mr. Fraser received his MBA from the University of Western Ontario and his BA from the State University of New York.

# Chapter 8

## TOOLS OF ACQUISITION: LETTERS OF INTENT, CONTRACTS AND CLOSING

Sheri Chromow and Andrew L. Jagoda, Katten Muchin Rosenman LLP

Letters of intent, contracts and closing are really three separate topics. A particular transaction may include all three starting with a letter of intent, continuing to a contract and, if all has gone well, culminating in a closing. It is possible to go from a letter of intent directly to a closing, depending upon the needs of the parties and the amount of detail contained in the letter of intent. Letters of intent, however, are usually non-binding agreements that set out the basic business terms of the deal and evidence the parties' intent to continue negotiations. From there, the parties will generally fill in the details of the transaction in a contract and then proceed to a closing. A letter of intent is not a necessary prerequisite to a deal; the parties often go directly to a contract of sale. A contract is not a prerequisite to a closing, although the parties generally want a written statement of their rights and obligations. The general practice in the US, however, is to execute a formal written contract of sale prior to closing because it will provide a more complete statement of the rights and obligations of the parties, the conditions to the parties' respective obligations to close, and provisions covering the remedies of the parties in the event of a default, than will a typical letter of intent.

### Letters of Intent

Generally, letters of intent fashion themselves to be just that — statements of the intent of the parties. They are usually non-binding by their terms, which means they should state specifically that they are intended only as an expression of the interest of the parties and that they are not binding upon the parties. Absent a clear and unequivocal statement to that effect, or a statement that the parties must enter into a binding contract on or before a date certain, a letter of intent can be, and in many cases has been, construed as a binding contract, usually to the detriment of a party whose rights would have been protected had there existed a formal written contract. Purchasers in particular would be unlikely to want to be bound by an outline of terms in a letter of intent with none of the protections that would typically be built into a contract. For this reason, if the parties wish to enter into a binding contract, they should negotiate an agreement that explicitly states their rights and obligations.

What purpose then does a letter of intent serve? It establishes the intent of the parties to proceed on a course toward a transaction on certain basic terms, and the letter provides some (hopefully non-binding) assurance to the parties that they have agreed to basic terms before undertaking the time and expense of negotiating a contract and performing due diligence. "Basic terms" in this context can include price and the amount of the downpayment, a timetable for establishing the contract, the mechanics of due diligence and other significant business terms. Additionally, a purchaser will want to include a no-shop provision, meaning that the seller will not enter into discussions with another prospective purchaser. The seller may agree to such a provision, but will usually limit the time it will keep the property off the market. The seller may request a downpayment or good-faith deposit in exchange for such a provision, although the purchaser will usually not agree, particularly if it has not yet performed its due diligence regarding the property. If the transaction does not go forward, any deposit may or may not be refundable, depending upon the size of the deposit, the purchaser's desire for exclusivity and the purchaser's willingness to forfeit any part of the deposit.

Provisions regarding the due diligence period will also be set forth in the letter of intent. If the due diligence includes any activity on the property, the seller will want adequate protection for any damage that the purchaser may do. Such protection may include an indemnity as well as evidence of insurance. The letter of intent should also contain a confidentiality provision to ensure that no part of the deal becomes public. A properly drafted provision will ensure that the existence of the transaction, the identity of the parties (and their principals), the terms of the transaction, and items delivered as part of the due diligence materials and inspections will not be disclosed to the public. The parties should consider whether the requirement for confidentiality should, by specific wording in the letter of intent, survive the expiration or the termination of the letter. The seller of the property, in particular, would be concerned about the disclosure of property information to the public. The letter of intent should require the purchaser to return to the seller all items delivered as part of the inspection (including all copies made by purchaser) if the transaction is terminated. In some cases, a seller will require the purchaser to provide copies of environmental and engineering reports commissioned by the purchaser, particularly if the purchaser does not go forward with the transaction.

The letter of intent will also include provisions related to brokers. It should contain each party's representation as to whether a broker has been involved in the transaction and, if so, which party is responsible for paying any brokerage commissions. In many cases, each party has engaged a broker and this provision should cover both brokers. Since brokers need only to prove that they have brought to the table a ready, willing and able purchaser, this is an important point. The party that "engaged" the broker is responsible for a brokerage commission, for which a claim may be made even if the transaction does not close. Additionally, any section of the letter of intent dealing with a brokerage commission should specifically provide that such section will survive the expiration or termination of the letter of intent. As a matter of practice, arrangements with a broker should always be made by a separate written contract, and the letter of intent should state that the broker will be compensated pursuant to a separate written contract. Such an arrangement will provide protections for the party that engaged the broker.

In summary, letters of intent identify the basic terms of a proposed transaction but are not always used. Instead, the parties may choose to go directly to a contract. Before entering into a letter of intent however, sellers or purchasers should be sure that it covers important points, provides that definitive documentation is still required and specifies that it is, by its terms, non-binding.

## Contracts of Sale

A contract of sale provides a road map of the purchase and sale transaction and is an allocation of risks between the parties. It should cover all of the needs and obligations of the parties, even though the two sides' needs and obligations will be different.

### Seller's Goals

The seller wants to achieve the highest price for the property. The seller also wants to achieve the highest possible degree of certainty that the sale will close and will therefore seek the fewest possible conditions to a closing. The seller will want to ensure that the closing will occur without undue delay, to limit any periods of due diligence, and to provide that time is of the essence with respect to any date set for closing (meaning that the purchaser cannot postpone such date). The seller will also want to have a clear right to claim and retain the deposit provided by the purchaser if the purchaser fails to close. The seller will also seek to minimize any post-closing liability by limiting representations and indemnities, the period of survival of any such representations and the damages related thereto.

### Purchaser's Goals

The purchaser's goals are virtually the opposite. The purchaser wants to minimize the seller's ability to elect not to close. Most importantly, the purchaser wants to confirm all significant information about the property by having access to materials like leases and permits, by having access to the property, and by having the seller represent and warrant that the information delivered and obtained from other sources is true and complete. The purchaser will want to be certain that the seller will be obligated to maintain the property between the time of the contract and the closing. The purchaser will also want to create seller liability for any failure by the seller to comply with its obligations under the contract.

### Standard Provisions

A contract of sale sets out the rights and obligations of the seller and the purchaser in order to satisfy each party that the other will consummate the closing of the sale on the agreed-upon terms. The contract will set out what the seller expects to convey and what the purchaser expects to acquire. In addition to describing in detail the parties, the property and the purchase price, the contract will spell out, in a section typically called conditions to closing, what each party must do and what each party is entitled to in order to effectuate conveyance of the property. The contract will contain representations about the property in its current state as well as the authority of the seller and the purchaser to enter into the contract. It will cover the scope of the seller's and the purchaser's obligations during the period between the contract and the closing. It will provide for a due diligence period, any deliveries, the closing, and the pro-ration of cash flow and payment obligations at the closing date. It will provide for what happens if either party fails to live up to its obligations under the contract or if the circumstances change (for example, if a major tenant defaults in its obligations under a lease or a material encumbrance to title is discovered). It will provide for what happens in the event that the property is taken for a public use or is damaged or destroyed before the closing. Many of these standard provisions are discussed below.

#### *Standard Provisions — Identification of Parties, Property, Purchase Price and Closing Date*

The contract begins with the names of the parties. The seller will want to be certain that the purchaser is an entity with sufficient assets to enable it to pay the purchase price at the closing, including the ability to obtain any necessary financing. The purchaser should ascertain at the contract stage all requirements its lender will impose as a condition of financing the purchase, and the purchaser should confirm that it will be able to satisfy those requirements. The purchaser may want to provide for future assignment of the contract, as it may want to form a new entity to take title. The seller will want to have the right to consent to any assignment or to limit the right to assign to affiliates of the original purchaser.

In identifying the property that is being sold, care should be taken that the property is sufficiently identified. To wit:

- Is the legal description adequate?
- Is there a current survey?
- Is there a minimum number of acres to be conveyed?
- What personal property, if any, is to be conveyed in the sale? (If personal property is included, there should be a bill of sale and if sales tax is applicable, the contract should provide which party will be responsible for paying it. Sales tax exemptions are state-specific and usually not available.)
- Are there any additional rights, such as rights to a building, that should be specifically conveyed?
- Are there any affirmative easements, guarantees of construction or air rights?
- Are there leases in effect? The contract should specifically include a copy of a current rent roll of leases and state that all such leases are included in the transaction.

The contract of sale should set forth the purchase price and provide for the downpayment. Sellers usually want a downpayment of 10 percent of the purchase price though purchasers will try to limit the amount, particularly if the purchase price is large. The purchaser will want the downpayment to be held in escrow by an acceptable law firm or a title insurance company. The escrow agent will want a separate escrow agreement or (if the escrow agent is the seller's law firm) a separate section of the contract, to set forth the terms under which the downpayment will be held and released. By putting the downpayment in escrow, the purchaser knows that the money cannot be commingled with the seller's other assets and that it will be notified before it is disbursed to the seller. The downpayment should be refundable if the seller fails to meet its obligations under the contract of sale, or fails to perform conditions that must be performed prior to closing. The downpayment should also be refundable if the purchaser's due diligence reveals problems. The terms concerning any refund or failure to refund should be clearly stated to avoid subsequent misunderstandings. From the seller's viewpoint, the downpayment should be forfeited by the purchaser to the seller if the purchaser fails to close in accordance with the terms and conditions of the contract.

The contract of sale will specify the time and place of the closing. The former may be a significant issue as the purchaser will want sufficient time to complete its due diligence and obtain any capital and financing it may need. The seller will want to proceed to closing without undue delay. If the contract does not contain a provision that time is of the essence for a closing date (which the purchaser will mightily resist), applicable law will generally entitle the purchaser to at least one adjournment (often understood to be up to 30 days). "Time of the essence" clauses enable either party to demand performance by the other on the date specified for the closing without permitting the other party to rely on its legal right to a reasonable extension of time. The seller may also be concerned about being able to put together all of its deliverables by a date certain. A contract may provide for either or both parties to extend the closing date, either to resolve a specific problem or at the discretion of one party, provided that such right to extend is exercised by a specified date and that following such an extension or the failure of the applicable party to exercise its right to such an extension, the obligation to close will become "time of the essence."

***Standard Provisions — Conditions to Closing***

The conditions to closing will reconfirm and require that each of the parties delivers all items needed by the other before either party is obligated to perform under the contract. The seller will want to be certain that the purchaser's representations are true and complete and that the purchaser has the ability to deliver the balance of the purchase price as required by the contract, generally by wire transfer. The seller will also require that the purchaser execute an assumption of obligations ongoing after the closing date under any leases and contracts being assigned. Most closing conditions will benefit the purchaser. The most important conditions are detailed below.

*Title*

The single most important condition to closing for the purchaser is that title to the property be conveyed subject only to approved encumbrances, which are usually set forth as an attachment to the contract. The quality of title and any encumbrances on it are searched and then insured by title insurance companies.

Insuring good title involves several steps. First, a title insurance report should be ordered, unless a current report exists. The typical contract requires that the purchaser order title insurance within a specified period of time and promptly notify the seller of any objections thereto. The purchaser's counsel will review the title report as well as the results of searches for liens, bankruptcy filings and violations of law and copies of all underlying documents, notifying the seller's counsel of any items to be corrected. A purchaser will want the contract to impose on the seller an absolute obligation to remove all mortgage and other monetary liens (such as mechanic's liens) the seller has consented to as encumbrances against the property or arising from work performed on the property at the request of the seller. The purchaser will want to negotiate for a provision that it is entitled to require the seller to remove objections it learns of subsequent to the initial report. The seller will attempt to provide that the purchaser will go forward with the purchase if defects are minimal or "curable" by affirmative title insurance. Title companies will provide affirmative insurance for encumbrances that do not pose high risks to the state of title. For example, affirmative insurance may be available for outdated restrictive covenants. The seller will typically seek a postponement of closing to give it time to cure any defects. The purchaser will want to be certain that the encumbrances it has agreed to accept title subject to are clear and do not hinder the use of the property for the purposes it contemplates or for resale, and that they will be acceptable to lenders providing financing for the property. If there is existing title insurance or a new title search has been run, either can be used to show permitted encumbrances. Another condition to closing will be the delivery of a policy of title insurance, in a form and with endorsements acceptable to the purchaser and any lender, although the seller will want to specify that such acceptability must be "reasonable" and not in the sole discretion of the purchaser or its lender.

The review of title and searches for liens, bankruptcies and violations constitute an important step in the process of insuring good title. Violations of laws like building codes may seem like small matters but the sections of the contract dealing with them can become the most contentious in the contract. Even though the purchaser will have an engineer inspect the building, these searches should always be done. The contract will require the seller to clear any such violations and the purchaser must be able to identify them in order to be able to take title to the property free of all violations, preferably with postings to be cured as close to the closing date as possible. The seller will want to have violations posted as early as possible, and it will not want to be responsible for removing all violations of record. In New York City, it can take a year or more from the time a violation is cured to have it removed of record. To prevent delays in closing or termination of the contract by the purchaser, a sophisticated seller will look for the opportunity either to cure violations or to post in escrow a sum sufficient to effectuate a cure. A purchaser should discuss any violations with its lender in order to determine the lender's requirements for their removal, since a lender may have more limited tolerance for violations than does the purchaser.

In addition to violation searches, a purchaser should also review the zoning designation of the property. Zoning laws regulate the uses of the property and the size and location of buildings situated on the property, affecting what can be constructed and operated on the property. Zoning laws may prevent industrial buildings from being built in areas designated for residential use. They may also limit the height of buildings or the portion of the property that may be covered by buildings and other improvements. Zoning is an exception to title, which means that title insurance companies will not guarantee that the property being conveyed is in compliance with local zoning laws. However, in most jurisdictions (although not New York) zoning endorsements are available.

Despite the extra protection that a zoning endorsement may provide, the purchaser will most likely want to do its own due diligence in the matter of zoning, although the seller will usually not want to make any representations about zoning. If the project is a site to be developed, the purchaser may insist on a zoning representation. The purchaser should require delivery of the certificate of occupancy as another condition to closing, and should inspect the property to make sure that its use complies with the certificate of occupancy. A certificate of occupancy indicates the permissible uses of the building that is being conveyed. For example, a 10-floor building may contain offices on every floor but the first floor may also contain kitchen facilities, which should be identified in the certificate of occupancy. Zoning rules may have been changed following the issuance of the certificate of occupancy, however, in which event the building will be permitted to remain standing as a legal, non-conforming use, but there may be limitations, in the event of a fire or other casualty on the permissibility of reconstructing the building to its pre-casualty condition. The certificate of occupancy will not provide any indication of such zoning changes. Accordingly, the purchaser should obtain a zoning report from one of the companies specializing in such analyses. A lender may be reluctant to provide financing for a building with a non-conforming use unless the lender knows that it can be reconstructed after a fire or other casualty.

As a condition to closing, the contract should also require delivery of a current survey showing the location of any improvements and all easements. Without a survey, a title policy will not insure that the legal description covers the property to be conveyed and the policy will except from coverage the possibility that portions of the building encroach onto adjacent properties, public roads or private rights-of-way. The contract should require that the survey be delivered in time for the purchaser, its lender and the title insurance company to review it and request changes.

*Representations and Warranties*

Another condition to closing concerns the truth and completeness of the parties' representations and warranties. The scope of these representations and warranties will be heavily negotiated by the parties and is the single most important part of the contract. Their purpose is to confirm the status of the property and the information provided by the seller. There will be an interrelationship between the due diligence rights of the purchaser and the scope of the representations and warranties. The purchaser will want the seller's representations to survive as long as possible after the closing, which the seller may resist.

*Documents to be Delivered at Closing*

The purchaser will want to be certain that each conveyance document is delivered, including a deed, a bill of sale, an assignment and assumption of leases, an assignment of contracts and transfer tax returns. The contract will describe the type of deed (which will vary from state to state). The purchaser will also want delivery of original leases, subordination and non-disturbance agreements, tenant estoppel certificates (delivery of which may be a condition to the purchaser's obligation to close, as discussed below) and letters to tenants regarding the transfer. The purchaser will require delivery of a title insurance policy, the survey, certificates of occupancy, building permits, management records, original leases and contracts, and copies of termination letters for any contracts being terminated. The seller will want the purchaser to deliver all documents containing the purchaser's assumption obligations. The purchaser should also provide the seller with copies of all consents, resolutions, incumbency certificates and other documents evidencing the purchaser's authority to enter into the transaction. Because the purchaser's title company will require the seller to deliver copies of all consents, resolutions, incumbency certificates and other documents evidencing the seller's authority to enter into the transaction, the purchaser should be sure that the contract includes a requirement that the seller deliver such documents at the closing.

***Standard Provisions — Pro-Rations***

A contract will provide for the pro-ration of cash flow and payment obligations as of and subsequent to the closing date. Contract provisions dealing with apportionments will need to cover all operating and maintenance items including, but not limited to, utilities, real estate taxes, rents (both fixed and additional — known as escalations), payments on any service contracts that are not being terminated, premiums on any insurance that the purchaser will continue, and vault taxes. If any type of management, leasing or brokerage agreements are to be continued, apportionments thereunder should be carefully reviewed. Even if the management contract is being terminated, care should be taken that no obligations to union employees carry over to a purchaser. Any state and local requirements should also be addressed; for example, in Chicago the seller should be required to supply a certificate from the water board.

Some items can be apportioned at and as of the closing date. For example, rents due under any leases (see below) will be apportioned as of such date. Negotiations will address who is entitled to the next payments of rent if there has been a default. The seller will want the first dollars applied to arrearages and the purchaser will want the same dollars applied to rent payable after its acquisition of the property. Security deposits under the leases will be allocated as a credit to the purchaser.

The contract should also specifically address the pro-ration of real estate taxes. Real estate tax calendars vary from jurisdiction to jurisdiction and local practices should be taken into account.

Transaction costs are also allocated as of the closing date. Participants will need to establish who pays such items as transfer taxes, title insurance, survey costs and brokers' fees, and expectations may differ according to location. In some states such as New York, if the purchaser pays the transfer tax, it will be considered additional consideration and will be added to the purchase price when the transfer tax is calculated. Custom varies regarding the payment of title insurance premiums. In some states the purchaser pays for the entire policy, but in others the seller pays for a basic policy and the purchaser for any additional affirmative endorsements. As in the letter of intent, the contract should specifically state that the broker or brokers will be paid pursuant to a separate written agreement.

Often addressed in its own section, the contract should cover any special assessment to be levied against the property. The general theory on which this section is negotiated allocates the cost to the party who benefits. Often the resolution is that if the special assessment has been levied or exists as a lien at the time that the contract is signed, payment thereof is the obligation of the seller. If the assessment is payable in periodic installments, the seller may agree to pay any installments due prior to the closing and the purchaser to pay those installments due following the closing.

As noted, the contract should provide that at some agreed-upon interval after closing, the seller and purchaser must provide information so that they can apportion any items which were not evident or quantifiable at the time of closing. Such items include real estate taxes that were not determined by the taxing authorities at the time of closing, tax and operating expense escalations payable by tenants, utility and other operating expenses, any unpaid lease-up costs and unpaid brokerage commissions. The seller will want to limit such period to minimize its outstanding liabilities. The contract will also deal with post-closing liabilities, such as those for breach of a representation. The seller may want to limit its post-closing liability for breaches of representations to a maximum aggregate amount. The purchaser will want to be certain that the seller will still have assets after it has distributed the proceeds of the sale. Often, purchasers will require sellers to post an escrow deposit, letter of credit or other evidence that the seller will be able to pay for any post-closing liability or apportionment.

Another area that should be covered in the contract is the proceeds of any tax *certiorari* proceeding received after the closing. The seller will want to make certain that it will receive payment for any refunds involving the period during which it had ownership of the property.

***Standard Provisions — Risk of Loss***

The contract of sale will contain a provision to deal with the risk of loss should the property be taken for a public use damaged or destroyed between the dates of the contract and the closing. In some states, common law allocates the risk of loss to the purchaser as soon as the contract is signed, but this allocation can be modified by agreement of the parties. In such situations the purchaser will require that a provision be added to the contract of sale to state the modification. If the property were damaged by fire or other casualty the seller would want to transfer the property to the purchaser and assign insurance proceeds without being required to make repairs. If a taking were to occur, the purchaser would want to be able to cancel the contract and receive a return of the downpayment, while the seller would want to transfer the property to the purchaser and assign awards for the taking. In most contracts the parties negotiate a threshold amount of damage to the property, often stated in dollars or square footage, below which the contract will remain in full force and effect, the purchaser will take title to the property plus insurance proceeds or awards, or the seller will complete the repair prior to the closing, and above which threshold the contract may be terminated. Such provisions may also establish that if the loss allows certain tenants to cancel their leases or restricts access to the building on the property the contract can be terminated.

**Leases**

Contracts of sale for office buildings contain provisions regarding leases, which constitute the heart of the property — they are the income stream. The purchaser of an office building will be particularly concerned about being able to obtain assurance that leases are in place and will generate expected revenues. The purchaser will also want the seller to covenant that it will comply with its obligations under the leases between the signing of the contract and the closing, and that it will not interfere with the cash flow. The purchaser will seek as broad a series of representations as possible from the seller, including representations that true and complete copies of all leases have been delivered, that the leases are in full force and effect, that the tenants are current in their rent payments, that there are no purchase options contained in any lease and that the seller has complied with all of its obligations under the leases, particularly the obligations to perform or pay for tenant improvements and leasing brokerage commissions.

While the purchaser will conduct its own due diligence on the leases, it will need confirmation that it can rely on the information received from the seller. Covenants will preclude the seller from canceling any existing leases or entering into any new leases in the interim. There will also be a provision for the seller to notify the purchaser of any defaults or other material matters concerning any lease during the interim between contract and closing. If any leasing activity is going on at the building, the purchaser will want to be included in the process and any decisions.

The purchaser will also want to require the seller to provide similar assurances from the tenants that the seller/landlord has complied with its obligations under the leases. Such assurances usually take the form of estoppel certificates from each of the tenants stating at minimum that the leases are in full force and effect, that there is no landlord default thereunder and that the landlord has complied with the obligations under the lease (particularly the obligations to perform or pay for tenant improvements). The seller will want to limit the percentage of tenants from whom it will be obligated to obtain estoppel certificates and, in addition, may seek to limit its representations about the leases to cover only those for which it has not obtained estoppel certificates. The purchaser will want to be certain that the estoppel certificates can be relied on by any lender and that they are current. In fact, the delivery of estoppel certificates may be a condition to the lender's obligation to fund the acquisition loan, and the lender may require that its own approved form of estoppel certificate be used. Investors may wish to keep in mind a couple of other points with respect to leases. First, since the purchase price will most likely be determined in part by a third-party lender requiring a mortgage on the property, if not in the lease itself, a contract provision should be added to require that leases will be subject and subordinate to any mortgage preferably, and at a minimum, to the mortgage that will be put on at closing. The seller should be obligated to obtain subordination and non-disturbance agreements where necessary on the lender's approved form. The purchaser should carefully examine brokerage agreements for each existing lease as brokers may be entitled to commissions on extensions or renewals of such leases. Lastly, the contract should account for all security deposits, whether in the form of cash or letters of credit, requiring at closing credit to the purchaser of cash, security deposits and assignment of all letters of credit to the purchaser.

**Breach of Contract — Limitation of Liability**

A purchaser's failure to take title subject to the seller's performance of its obligations under the contract gives the aggrieved seller a choice of remedies between money damages and specific performance (a court-ordered conveyance of the property). A purchaser that announces in advance that it cannot or will not perform may be in anticipatory breach of its obligations under the contract. The seller's damages are generally measured as the difference between the purchase price and the market value of the property at the time of the breach. The seller will want to be able to require specific performance of the contract, although courts rarely enforce specific performance provisions.

To mitigate the seller's rights, the purchaser will attempt to negotiate a contract provision that establishes liquidated damages as the seller's sole remedy. The amount of such damages can be measured by the downpayment or as a percentage of the purchase price. Such a provision is generally enforceable in most states, but the amount of the damages must bear some reasonable proportion to the purchase price to be enforceable or it may be unenforceable as a penalty. The provision should also provide that the liquidated damages represent the seller's sole remedy. Contracts do typically provide for such a liquidated-damages remedy and stating that the parties agree that it is impractical to ascertain seller's damages and that the amount of the downpayment serves as a reasonable estimate.

Similarly, if the seller breaches the contract or fails to perform, the purchaser will be entitled by law to the same remedies (*i.e.*, money damages and specific performance). In most states the purchaser may recover damages for its loss of the bargain in addition to the recovery of the downpayment, or it may sue for specific performance. The seller will attempt to limit its liability, usually to return of the downpayment, possibly to reimbursement of the purchaser's out-of-pocket costs (such as those associated with due diligence or title and surveys). The purchaser will negotiate for additional seller liability, particularly in the case of a willful breach by the seller. For example, if the seller willfully conveys the property to a third party in violation of the contract, the purchaser's recovery should not be limited. A purchaser will also want the right to file a *lis pendens* against the property in order to put other potential purchasers on notice that the purchaser has a claim against the property and is seeking to enforce it. A seller will seek to require that the purchaser not be in default and remain ready, willing and able to close in order to exercise its remedies. A seller may also seek to restrict the ability of a purchaser to exercise its remedy of specific performance by requiring that the purchaser commence any litigation to that end within a specified period of time following the required closing date.

**Other Noteworthy Points About Contracts**

State law is not uniform across the US, nor are real estate documents. Generally, the governing law of the contract is specified as that of the *situs* (location) of the property. Many forms of deeds exist, including quitclaim deeds, bargain-and-sale deeds (with and without covenants) and warranty deeds. Remedies and contract provisions may be enforced differently, and the bases on which real estate taxes are calculated differ. As mentioned already, the costs of the transaction and customs as to which party pays which costs will vary as well. The sophisticated purchaser will take state differences in hand.

The seller will frequently require that the obligations of the purchaser to close are not contingent on the purchaser having obtained acquisition financing. Accordingly, prior to executing the contract the purchaser should be certain of its ability to obtain financing to fund the purchase.

Often one or both of the parties wishes to include a provision permitting a "like-kind exchange." Section 1031 of the Internal Revenue Code permits a party to defer payment of income taxes on the sale of one property by using the proceeds of its sale to purchase another similar property.

## The Closing

A well-organized closing is the result of preparation that begins promptly after the execution of the contract of sale. The purchaser should arrange to do its environmental and engineering due diligence if this has not already occurred under a letter of intent. The purchaser should order title insurance and review copies of all documents affecting title. The purchaser should arrange for review of all leases, management agreements and any other contracts that may affect the property. Copies of all documents should be made available promptly to the institution providing financing. A closing checklist should be prepared to indicate what deliveries are required by both the seller and the purchaser. The parties should prepare a closing statement to include closing adjustments. With these tasks completed, the jobs of the purchaser, the seller and their counsel at the closing will be easy and the event will consist of a mere exchange of documents. In the real world some, or many, of these matters are handled at the closing table.

The purchaser will want to obtain all the instruments and documents necessary to establish title and to enforce its rights and perform its obligations as owner of the property. In addition to checking the contract of sale, the purchaser will inspect the property immediately before the closing to ensure that no loss or damage has occurred. Before or at the closing the parties should decide upon closing adjustments, even if last minute changes may be required.

The purchaser will verify that the seller's actions are authorized and that any required consents have been obtained. The purchaser will then review the seller's deliverables to make sure that all items required to be delivered by the contract of sale have been provided. These "deliverables" include:

- the deed
- original leases and brokerage agreements with assignments thereof
- original security-deposit letters of credit with assignments thereof
- estoppel certificates (which must be reviewed to verify that there are no defaults and that the rent payable is consistent with the purchaser's expectations)
- if required, executed subordination and non-disturbance agreements
- notices to tenants of the transfer of the property, providing addresses to which they will submit rent payments and other notices to the purchaser
- service contracts being assigned with assignments thereof, and or evidence of termination of service contracts
- any management agreements and software programs
- title insurance policy (from the title company)
- certificates of occupancy, building permits, licenses
- transfer tax returns
- bill of sale
- documents evidencing the seller's authority to complete the sale
- utility contracts
- guarantees of construction, repairs and renovations, and copies of plans and specifications used to construct the building
- an affidavit confirming compliance by the seller with the Foreign Investment in Real Property Tax Act (Internal Revenue Code Section 1445), which requires the withholding of a certain portion of the purchase price in the case of certain non-US sellers of real property
- a certification by the seller that its representations and warranties in the contract remain materially true and correct as of the closing date
- keys.

At closing the purchaser should have its insurance in place and should have the money available to pay the balance of the purchase price in the manner required by the contract.

By way of logistics, not all closings take place in one location with all the parties present. Frequently, closings are effected by escrow arrangements with the purchaser's title insurance company. In such arrangements the parties deliver the closing documents and funds to the title company, which distributes them pursuant to escrow instructions and a closing statement signed by the parties. Very often final documents and other deliverables, particularly documents that are not to be recorded in the public land records, are distributed by e-mail and facsimile during the closing. Although some states permit the use of electronic and facsimile signatures on documents that will be recorded, most do not. Furthermore, electronic signatures are not yet enforceable in all jurisdictions.

Although many issues must be addressed when conveying real property, a thoroughly negotiated contract will cover all rights and obligations of both parties and, if all terms are complied with, the closing will result in a smooth transition of the property from seller to purchaser.

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Sheri Chromow, a partner in the real estate practice at Katten Muchin Rosenman, has extensive experience in a wide range of real estate transactions. Her practice, international in scope, encompasses financings of all varieties, including structured, syndicated, securitized and construction; joint ventures and partnerships, including the establishment of public and private REITs and funds; and acquisitions and dispositions of assets. Ms. Chromow has worked extensively on hotel development, management and financing projects, as well as workouts, enforcements and restructurings.

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Andrew Jagoda, a partner in the real estate practice in Katten Muchin Rosenman, has represented a wide range of US and overseas clients, in both the private and government sectors in a wide variety of real estate transactions, including financing, restructuring and disposition of distressed real estate assets, development, construction and leasing. Mr. Jagoda served as counsel at the Resolution Trust Corporation, and also represented the People's Republic of China in a series of structured bulk sales of over $1 billion of non-performing loans and foreclosed properties.

# Chapter 9

## LEASING AND MANAGING US REAL ESTATE

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The negotiation and documentation of leases and management contracts follow varying conventions for retail, residential, industrial and other real estate types. The comments in this chapter address institutional-quality office buildings in major US markets. Investors should always be aware that US local and federal governments do not set statutory rules for the business terms of leases or management agreements.

### Law

#### Leasing and Management Law in the US

The business terms of leases for US properties are determined almost exclusively by mutual agreement between landlord and tenant. Local and federal government rules focus very little on establishing how business terms should be crafted. However, many government rules exist for resolving conflicts and protecting the rights established in the lease. These rules also allow the parties to elect to resolve certain disputes by arbitration rather than in a court of law. Since landlords and tenants have the right to agree on most terms, lease documents tend to be long in the US, ranging from 20 to over 150 pages for larger leases in major markets.

All leases for terms longer than one year must be in writing and the lease document governs most of the rights and responsibilities of each party. Certain local conventions and standards have emerged to simplify the creation of new leases, although these standards need not be, and often are not, followed. The complexity and uniqueness of the document increases the attorney's role in US lease negotiations.

#### The Broker

In addition to the attorneys, many office tenants will work with a broker or agent. The tenant's broker may do as little as locate the property and recommend and relay proposed terms for a space. Alternatively, the broker may serve as a full-blown real estate advisor helping with all aspects of the tenant's real estate process. The full-service broker finds space, helps to determine site selection, develops growth projections, coordinates space planning, selects consultants and negotiates the lease document with the attorney.

Oddly, the law in most states dictates that the landlord pays the tenant's broker, generally in the form of a commission. Occasionally, the tenant pays its broker with a fixed fee, or controls the commission by requiring the broker to pass on a portion of its commission to the tenant. (This fee-splitting scenario usually applies to larger transactions.) In some jurisdictions, the law requires that the tenant sharing the commission hold a broker's license.

The broker's involvement is very important to transactions in the US. Often, the landlord deals exclusively with the broker through much of the marketing, touring and negotiation.

The amount of the commission varies by market, although the landlord's broker generally gets 50 percent of the amount paid to the tenant's broker. In Boston, Chicago, San Francisco and Silicon Valley, commissions are calculated as a fixed dollar amount per square foot per year ($0.90 per square foot per lease year in Chicago, for example). In Houston, Washington, DC, New York and Los Angeles, commissions are calculated as a fixed percent of lease rent per year (4 percent of total lease in Washington, DC).

### Typical Lease Terms and Provisions

Each market in the US has its own conventions and standards for lease terms and provisions, and they can vary significantly. The same phrase may represent different expectations and standards in different markets. The foreign investor should be careful to understand the lease terms in the context of the local market. The most important lease terms are discussed below.

### Space Measurement

In most of the US, rentable area is based on a measurement standard created by a real estate association named BOMA (Building Owners and Managers Association). This standard measurement adds common-area space (main lobby, equipment rooms, *etc.*) to the tenant's demised premises, providing the landlord with rent for all parts of the building. Local practice will influence what kinds of space qualify as rentable common area. In New York City, the standard of a local association, the REBNY (Real Estate Board of New York), is used. According to the REBNY standard, landlords may adjust rentable area somewhat subjectively, effectively using square feet as an additional variable to establish total rent.

### Demised Premises Condition

The expected delivery condition of space to be constructed or renovated varies by market as well. In Houston, the landlord is expected to install the ceiling and building-system extensions above the ceiling. In New York City, the tenant would generally be responsible for constructing all of the improvements within its space, including the ceiling and the building-system extensions from the core of the building. In each market, the delivery condition of unimproved space is referred to as "shell" or "raw." In all cases, investors should be sure to understand local expectations for delivery condition so that appropriate capital allocations can be made.

### Base Rent

Base rent may be expressed as a net rent or a gross rent. In most US markets, leases are written in terms of gross base rent. In these cases, the tenant pays high enough rent to include the landlord's annual operating cost for the initial year of the lease. In subsequent years, the tenant pays the prescribed gross base rent plus any increases in annual operating costs (see "Operating Expense Recovery" on page 66). Capital repairs and improvements to the building are generally at the landlord's cost. New York, Boston, Houston, Los Angeles, San Francisco and Washington, DC, properties tend to write gross-rent leases.

With gross leases, the investor needs to understand what is specifically included. In some markets, particularly New York City, gross-rent leases may not include all expenses, leaving those like electricity or cleaning to the tenant, who must pay for those services separately, often with a built-in extra profit to the landlord.

In net-rent leases, the tenant will pay, in addition to base rent, all of the annual operating costs of the building including taxes and general repairs. In a typical net-lease deal, the landlord maintains control of the operation of the building but the tenant(s) may have some authority over how it is managed. Chicago properties tend to write net-rent leases.

Sometimes leases are written as "triple"-net rent. Triple-net rent means the tenant pays all operating costs (including capital repairs and improvements), real estate taxes and insurance. Normally, triple-net leases are used for single-occupant buildings for terms longer than 15 years. The tenant will often take full responsibility for all aspects of managing the property.

Increases in base rent are included in almost all commercial office leases, as local market conventions dictate. The increases may be determined by an index, such as inflation, or by a nominal or a percentage growth. The frequency of increases will be negotiated, but market norms will influence the outcome. Though most office leases have a base-rent increase requirement, standards vary even within a market.

Base rents are quoted on a monthly or an annual basis. The Los Angeles and Silicon Valley markets quote a monthly rate while San Francisco, Washington, DC, Houston, New York, Boston and Chicago quote on an annual basis.

### Term

Lengths of term for office leases vary. Generally, the shorter leases are for smaller spaces and the longer terms for larger tenants. Most large markets will have average lease lengths between five and 10 years, although in New York, leases of 15 to 20 years are not uncommon. During the term of the lease, neither the landlord nor the tenant has the right to terminate the relationship unless specifically provided for in the lease. Absent this, usually neither party will have a right to terminate except in certain extreme cases of non-performance.

### Landlord Cash Contribution

Most new leases in the US require the landlord to pay for a certain negotiated amount of the tenant's build-out. The dollar amount may be called "landlord's contribution" or "tenant improvement (TI) allowance" or "cash contribution." A key aspect of this arrangement is whether the landlord's funds are treated as a reimbursement of costs paid by the tenant or as a direct payment by the landlord to contractors. The structure and flow of these funds from the landlord will dictate additional lease provisions necessary to protect the landlord from potential claims or property liens by contractors.

In some markets, the landlord's cash contribution will pay for the entire construction of the tenant's space. More commonly, the landlord's cash contribution is viewed as a concession to the tenant, which pays a portion of the cost to build out its space. In such cases, additional lease provisions are advised to ensure completion of the project. This is particularly important when the tenant controls the construction project.

### Tenant Improvements

The conventional process of improving space for a new lease entails the landlord or the tenant directing the construction of improvements designed specifically to meet the tenant's requirements. The condition of the space delivered is negotiated but is subject to local practices.

Typically, the standard for delivery falls into one of three broad categories: "shell," "as-is" or "turn-key" condition.

In shell condition, any prior improvements to the space would have been demolished by the landlord and the space would be ready for new construction in accordance with the tenant's design. Often, the landlord would be responsible for the cost of ensuring code compliance in the raw space and for providing connection points to all building systems. The lease would establish the extent to which the landlord and tenant are each responsible for subsequent improvements.

As-is condition describes premises previously occupied and delivered to the tenant for re-use of some or all of the improvements. Any modifications necessary for tenant occupancy (by whom and at whose cost) would be negotiated as part of the lease.

In turn-key condition, the premises have been constructed or reconstructed by the landlord for the tenant. The obligation of the landlord is defined by the tenant's scope of work for improvements rather than by a cash allowance, putting the burden on the landlord to deliver space that satisfies that document's negotiated specifications or a set of construction plans. The landlord will often seek to cap the maximum cost incurred and will always prepare a detailed construction budget before taking on a turn-key obligation. The tenant will seek to bear no responsibility for the premises prior to occupancy and will accept the space only when all work is complete.

In some markets, a landlord might follow a strategy of constructing a small office unit (2,500–10,000 square feet) and marketing it for immediate occupancy. The work that remains incomplete could be as basic as laying carpet or painting walls. By constructing such "pre-built" units, the landlord seeks to reduce the lead time necessary to deliver vacant space to a new tenant, accelerating rent commencement. However, the strategy limits the tenant's control over the design, so the landlord must establish pre-built standards that appeal to a wide range of prospects, can be completed promptly and permit minor changes. A pre-built unit is essentially a turn-key unit in which the landlord takes construction risk without having a tenant in hand.

When a tenant's lease expires, the landlord will own the improvements. Any residual value that can be realized in re-letting the space using existing improvements is entirely for the benefit of the landlord. Lease provisions can establish certain improvements or fixtures that a tenant may or must remove.

The landlord will conduct reasonable review of all plans and work in order to ensure proper ties to major building systems, and that the design and construction practices meet safety requirements. Furthermore, because ownership of the improvements at expiration of the lease goes to the landlord, the landlord must be particularly attentive to identify, and require that the tenant remove at expiration, any specialty improvements that would present a liability. These could include vaults, internal stairways, shaftways, computer rooms, *etc.* The landlord's ability to make such decisions rests on the provisions negotiated in the lease.

The treatment of specialty improvements is tied to the concept of "restoration." A landlord will often seek to include provisions in the lease that require the tenant to restore the premises to the condition in which they were delivered at commencement of the lease. This provision can have significant economic value to the landlord in reducing the cost of re-letting the space.

### Operating Costs

As described in the gross-base rent section, most tenants pay a fixed rental amount plus annual increases in operating expenses. The term "base year" refers to the year that both parties agree will be the start of the lease for purposes of calculating operating expense or real estate tax increases.

**Responsibilities of Landlord and Tenant**

Though the responsibilities of landlord and tenant are unique in each lease, generally the landlord is responsible for the structure of the building, the building's main systems and its common areas. Generally, the tenant is responsible for everything within its demised premises. These responsibilities tend to include repairs and maintenance, tenant insurance coverage, liability for people's actions within each area and compliance with laws.

**Remedies**

If the landlord does not perform its obligations under the lease, the most common remedy is for the tenant to sue for specific performance. If the tenant does not perform according to the lease, the most common remedies for the landlord are to fix the problem and charge the tenant or to evict the tenant. In most states in the US, it is difficult for the landlord to evict a tenant with an operating business, even if the tenant is not paying rent.

Landlord-tenant litigation in the US can be expensive and slow. The lack of governmental rules for lease terms means a judge must make individual decisions based on the specific lease and the merits of each party's situation. Normally, courts will prefer to err in favor of the tenant for extended periods.

**Options**

Options are generally granted to larger tenants and only infrequently to small tenants. The most common option is one to renew at the end of the lease term. Most renewal options stipulate that the rent will be set just prior to the start of a new term, usually at the fair market value or a percentage thereof. Other common lease options include expansion (giving the tenant a right to a defined space at a defined time), termination (giving the tenant a conditional right to cancel the lease at a certain time), right of first offer (giving the tenant the first chance to lease a specific space when it becomes available) and right of first refusal (giving the tenant the last chance to lease a specific space when it becomes available and a third party has offered to lease the space under specific terms). The foreign investor should be particularly careful in analyzing existing options because such encumbrances often create significant value implications.

**Credit Enhancement**

Landlords typically require tenants to post some security, or collateral, against the tenant's obligations. Almost exclusively, such collateral is in the form of a cash security deposit or a bank letter of credit. The amount of the collateral is determined individually for each lease, taking into account the tenant's credit and market conditions. Some tenants are also asked to provide a better-capitalized parent or affiliate company's guarantee of the lease or an individual's personal guarantee of the lease.

## Property Management

**Management Contract**

The management contract establishes the relationship between the owner of a property and the company providing the services required for the ongoing operation of the property. The agreement details how various matters concerning the property are to be managed and paid for, and establishes an expected level of service. The fee for this service may be a flat fee or one calculated based on gross revenue or on property size. In many cases, the party providing the service on behalf of the owner is a professional third-party management company.

A typical management agreement in the US will provide the following:

- property data
- definition of terms used
- delegation and or limitation of the manager's authority to contract

- management responsibilities and compensation to include such items as management of bank accounts, response to tenant complaints, collection of rent, creation of budgets, hiring and training of staff, maintaining payroll and payroll taxes, review of plans for tenant improvement
- leasing responsibilities and compensation
- insurance coverage
- length of contract
- items such as provision of management office space, arbitration measures, indemnification and procedures to be followed in the event of a sale to a third party.

As is the case with leasing practices, local markets may apply different standards and terminology. Management agreements are highly variable, both in form and in substance. Despite the fairly dramatic differences that do exist in the US, management fees remain a major factor in investment analysis, as do the level of services expected by the tenant and the owner. Understanding the management company's responsibilities — and the interrelationship between the management personnel and the leasing personnel — is vital to analysis of an asset from an operational perspective.

### Management Fees and Services

Fees too vary with each market and are often negotiated to reflect services provided within two categories — overall management and oversight of capital projects (whether undertaken by the tenant or the owner). Where possible, the owner will escalate these fees as part of the operating costs of the property. The amount ultimately escalated will be determined by standard market practices and individual lease negotiation.

The overall management fee is typically either a flat fee or one based on gross revenues or square footage. The range in the US for these fees is generally 1 to 3 percent (or more) of gross revenues (usually higher for smaller properties). Fees tied to building area may be as high as \$0.75–\$1.00 per square foot, in contrast with some European markets (like Paris) where the fee is typically in the range of £7.5–£9.0 per square meter (FF50 to FF60 per square meter or \$0.65–\$0.77 per square foot). The percentage model clearly keeps the incentives of the management company and the owner aligned, as each benefit from higher property income.

Also, sometimes embedded in the management agreement and charged separately is a fee for the oversight of capital improvement projects. These projects, whether on behalf of the owner or the tenants, are valued as including both "hard" and "soft" costs, and the management fee is determined by applying a percentage to the total. In Manhattan, rates for this fee can be as high as 10 percent but are negotiated based on the scope and complexity of the project and other factors.

Management companies in the US perform a wide array of services, some of them not typically provided in other countries, or perhaps assigned to other parties such as asset managers or construction managers. Because property management is not a simple commodity, a low-cost provider may not be appropriate for many properties. Institutional-grade investment properties are usually complex facilities that require sophisticated capabilities, such as energy management, project engineering, real estate tax management and labor relations. For many investors, the resources and skills of a high-quality management firm readily outweigh the expense.

### Operating Expense Recovery

The method by which a landlord recovers expenses and real estate taxes under a lease is a major focus of negotiations. The structure can take almost any form agreed to by the parties, but it is influenced heavily by local market practices. Considerable management attention is required to evaluate the timing and impact of new expenses. Furthermore, the administration of the expense recovery provisions can be one of the most complex and time-consuming aspects of managing the asset.

The basic models of expense recovery were referenced in the discussion of rent provisions. The rent values established in a lease are directly tied to the method of expense recovery. As noted, gross leases permit the recovery of some of the operating costs and taxes attributable to the leased space. A net lease will burden the tenant with all such costs. A triple-net lease can burden the tenant with all expenses of operating, maintaining and restoring the premises — effectively all the costs of ownership except for the mortgage. Regardless of the method used for expense recovery, all of the terms and obligations are negotiable.

A gross lease will typically establish a base year (or a "base stop") for operating expenses and taxes. (The base-year period is negotiable, but it typically is the first calendar or fiscal year during which the lease is in effect.) The base-year value is effectively the portion of expenses and taxes the landlord bears; any increased costs above that amount are the tenant's expense. The base-year amount can be a fixed, negotiated amount established in the lease or it can be established once the actual costs are incurred during the base-year period. Minimum or maximum values can be negotiated for base-year values and the annual increases can be capped.

For good reason, considerable attention is given to the lease provisions governing what costs qualify for tenant reimbursement. Market standards have great influence on what is deemed acceptable. Generally, costs associated with capital improvements, leasing and services not provided to all tenants would be excluded from the pool of escalatable costs.

A simple method of recovering expenses is to increase rents according to the US Consumer Price Index (CPI), published by the federal government and readily accessible. Rent can be negotiated to increase in some relation to changes in the CPI. Furthermore, CPI growth formulas can be used to cap expense recoveries so that expenses that exceed such a limit are not reimbursed by the tenant.

Although not often used in new leases, the "Porter's Wage" method is prevalent in existing New York City leases. This structure increases the tenant's rental in relation to increases in the wage earned by unionized porters. Porter's Wage can be a simple calculation (like a CPI increase), but is widely regarded with unease because there is no clear relationship among increases in total operating costs of a building, a porter's hourly wage and the rent growth resulting from use of the formula. As with all aspects of the lease, such provisions are negotiated extensively and complex variations are common.

The US market allows parties involved in leasing office-building space to negotiate lease and management agreement terms that suit their interests. In contrast to many non-US markets, governmental rules do not dictate the length of term, security deposits, renewal options or many other specific terms. The result is lengthier agreements with more negotiation and the opportunity to choose arbitration to resolve disputes. To understand a property's relative risks and opportunities, therefore, the investor needs to be aware of the specifics of each transaction and of local market conventions.

Many property-management firms have the broad capabilities to oversee complex assets. The cost of engaging a third-party manager is negotiable, yet directly tied to the services to be provided. An investor seeking a low-cost fee structure must recognize the limitations such structures impose. When making such an arrangement, the investor must provide asset-management expertise and direct day-to-day involvement to compensate for the reduced contribution of the agent.

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# Chapter 10

## REAL ESTATE FINANCE, PART I: THE LENDER'S PERSPECTIVE

Thomas Broschek, Landesbank Baden-Württemberg (LBBW), and Sebastian Kaufmann, King & Spalding LLP, with significant contributions from Sheryl Kass, King & Spalding LLP

### General Matters for Consideration in Financing Real Estate in the US

#### Lending Platform

Before engaging in lending activities in the US, a foreign lender should determine whether there are any federal or state licensing or other requirements to be met. If the foreign lender is a bank, it may engage in lending activities in the US either directly from offshore or indirectly, through a corporate (non-bank) lending subsidiary, a bank branch, agency or representative office established in the US. Legal counsel should be consulted to carefully analyze the regulatory requirements.

#### Type of Investment

A foreign lender can take either one of two main approaches to make loans secured by real estate located in the US. It can act as the originating lender of a mortgage loan or it can participate, through the secondary loan market, in a mortgage loan originated by another lender.

##### *Loan Origination*

As an originating lender the lender will have the relationship with its customer (the borrower) and will source the loan. It will negotiate the loan documents directly with the borrower using its own loan documents and customize them to reflect the specific terms of the financing. Note that for large real estate financings in the US there is no set form of loan documents that all banks use and loan documents are typically voluminous and can be complex. Each bank will start with its preferred form documents, which are usually prepared and reviewed by outside counsel. If the originating lender does not intend to hold the entire mortgage loan on its books, it will seek to participate the loan to one or more other lenders. It can arrange a deal with the other lenders before starting negotiations with the borrower (a "club deal"), it can underwrite the entire loan and invite others to participate later. In the former case the participating banks will jointly agree on a term sheet and will provide input to the agent or lead lender throughout the negotiations of the loan documents. In the latter case the participating banks will come in after the term sheet and loan documents have been negotiated and signed (and will thus have limited input). A participating bank that finds the loan documents unacceptable may decide not to participate or may condition its participation on changing the documentation (which may not be possible if the loan documents have been signed and the borrower is not willing to make the change).

### *Club Deals and Participations*

A lender can participate in a mortgage loan as a co-lender or as a participant. A co-lender will be a party to the loan documents, will typically receive its own note from the borrower evidencing its interest and thus will have direct privity with the borrower (meaning that the co-lender will have a direct contractual relationship with the borrower, even though co-lenders usually are permitted to deal with the borrower only through the agent or lead lender). A participating lender buys an ownership or participation interest in another lender's loan and therefore is not a party to the loan documents, will not receive its own note and will not have privity with the borrower. The terms of a participation will not be set forth in the loan documents (because the participant is not a lender) but will be laid out in a participation agreement between the lender and the participant. A participant's risk is twofold, including the credit risk of the lender granting the participation interest as well as the indirect credit risk of the mortgage borrower and the collateral.

Note: The terms "lender" and "participant" are often used without distinction as to their technical meanings. In this chapter the term "lender" describes a lender that has direct privity with the borrower and the term "participant" describes an entity that is technically not a lender but invests in another lender's loan without any legal relationship with the borrower.

### *A/B Loans*

In addition to syndicating a mortgage loan to multiple lenders or participants, the originating lender may decide to divide the loan into a senior and one or more junior pieces, in a so-called A/B structure. Such structures are devised to attract and accommodate investors with different profiles. In an A/B loan, the lenders have the same borrower and the same collateral (the mortgaged property) but agree contractually on a payment waterfall that creates two or more levels of seniority among the lenders. A typical A/B co-lender agreement will provide that, following an event of default (or other triggering event), all proceeds from the collateral will be used to repay the A note until its balance is reduced to zero before any payments are made on the B note. The B lender is compensated for this subordination and increased risk by receiving a higher interest rate on its note than the A lender. The weighted average interest rate of the A and B notes equals (at least initially) the interest rate set forth in the loan agreement (the weighted interest rate may increase, for example, if there is a disproportionate reduction of the A note over the B note following a "flip" to the post event of default waterfall). The co-lender agreement will also set forth the respective consent rights among the lenders and may provide that the B lender will initially control certain decisions. The rationale often provided for granting a junior lender "controlling lender" status is that the junior lender will suffer the first loss from a deterioration of the financing and collateral and therefore will have the greatest incentive to maximize value. The B lender will lose these control rights, however, if — stated simply — the value of the collateral less the outstanding principal balance of the A note falls below 25 percent of the controlling lender's outstanding principal balance. (Such a development is described as a "control-appraisal event.") Sometimes the B lender can retain its rights as the controlling lender by putting up collateral in an amount which, when added to the value of the property, will keep it at or above the 25 percent threshold and avert a control-appraisal event. Notwithstanding a B lender's status as controlling lender, the A lenders typically retain the right to consent to modifications of key terms of the loan, such as the amount of a lender's commitment, the interest rate, payment terms or the release of collateral. The co-lender agreement typically grants the B lender the right to cure a borrower's default under the loan documents, enabling the B lender to avoid the negative consequences such default may trigger under the co-lender agreement. An example of such negative consequences would be a change in the payment waterfall brought about by an event of default. Such a cure would only take effect between the lenders — the borrower would remain in default. The co-lender agreement also typically grants the B lender the option to buy out the A note at face value, including interest upon certain trigger events (usually including certain material defaults under the loan documents).

*Mezzanine Loans*

If the borrower needs more funds than the mortgage lenders are willing to provide, a financing may be structured to include a mezzanine level of debt. In this situation a structurally subordinate mezzanine loan is made not to the mortgage borrower, but to its parent. Unlike the mortgage loan, the mezzanine loan to the parent of the mortgage borrower is not (directly) secured by the real estate, it is typically secured only by the parent company's ownership interest in the mortgage borrower. If a mezzanine loan is part of the overall property financing structure, an inter-creditor agreement will govern the relationship between mortgage and mezzanine lenders. The mezzanine loan structure is discussed in detail elsewhere in this volume.

*Conduit Market; German Pfandbrief*

If the originating lender contemplates selling all or a portion of the mortgage loan into the conduit or securitization market, the documentation, closing and post-closing processes must be designed to qualify for the intended program (for example, compliance with rating agency and REMIC requirements). German banks that intend to include US mortgage loans in the cover pool for covered mortgage bonds issued by the bank under German law (*Pfandbriefe*) must comply with the applicable legal requirements. For example, the mortgage loan (or portion thereof) held by the lender must be directly secured by the real estate (loan participations are not eligible for inclusion in the cover pool), the loans must meet certain minimum requirements regarding the lender's ability to exercise rights against the collateral in multi-lender financings, and the borrower should waive any rights of set-off. In addition, the loan documents should provide that the lender's interest may be collaterally assigned to a security trustee acting on behalf of German covered bondholders.

**Type of Loan**

Mortgage loans can be placed into two broad categories: permanent loans and construction loans. Permanent loans are used to acquire, restructure or refinance real property, while construction loans are used to build improvements on or otherwise develop property. Please see Chapter 11: Real Estate Finance, Part II: The Borrower's Perspective for more background on these types of loans.

**Type of Asset**

A foreign investor seeking mortgage lending opportunities needs to consider the location of the property, its cash flow and its use, or intended use. Commercial real property includes office, retail, multifamily, hospitality (*i.e.*, hotels) and industrial properties. Each of these requires a different capital structure and will result in a different level of return, so the type of use must be taken into account when determining the terms of a mortgage loan.

**Applicable Law and Jurisdiction**

Dealings in real estate are governed by the law of the state in which the property is located. Although the loan documents for the debt may be governed by the law of any state the parties choose (often New York), it is the documents creating the security interest in the property (*i.e.*, the mortgage or deed of trust and assignment of leases and rents) that are governed by the law of the state where the property is located. When the need arises to enforce rights against real estate collateral, typically the state court in the county in which the mortgaged property is located will have jurisdiction.

### Due Diligence and Underwriting

Before a lender agrees to provide a mortgage loan, the lender should diligently research the borrower, the property to be mortgaged, and the micro- and macro-conditions of the property market. Mortgage loans in the US typically do not grant a lender recourse to the borrower. This means that the borrower is not personally liable for the loan and that the lender's only recourse is to the mortgaged property. Since the lender is usually advancing the majority of the funds to finance the property and may end up owning the property if the loan defaults (discussed in Chapter 30: Restructuring and Workouts of Real Estate Loans), the lender should conduct the same due diligence that a buyer of the mortgaged property would conduct.

#### Borrower/Sponsor

Even though mortgage loans are non-recourse, the borrower's financial condition is still important in determining the viability of the project being financed. Since mortgage loans are made to single-purpose entities whose sole asset is the mortgaged property, the lender needs to look not only at the financial condition of the borrowing entity, but also at the character and financial condition of the entities or individuals that ultimately own the borrower and are involved in other substantial business activities (known as borrower parties). The lender should consider the reputation, competence and prior track record of such entities to the extent that they have owned or developed properties similar to the mortgaged property. The lender can obtain this information by requesting a list of the borrower parties' prior projects and speaking to major tenants, contractors, architects, managers and others who have interacted with the borrower parties in connection with such projects. The lender should review the borrower's financial statements and other financial information to determine its financial ability to successfully complete the investment for which it is seeking financing. The lender should continue to monitor the borrower's financial situation during the term of the loan and should require ongoing reporting (Germany based lenders need to be mindful to consider the ongoing reporting requirements under Section 18 of the German Banking Act (KWG)). The lender should also request a list of any litigation in which the borrower parties are involved, as it may affect the overall financial capabilities of the borrower. Independently, the lender itself will need to search the various court dockets for any such litigation.

In addition, the lender should obtain from the borrower an organizational chart showing the relationship between the borrower parties. It will also need to see the organizational and authority documents of the borrower parties (their certificates of formation, operating agreements, certificates of good standing and resolutions approving the loan). It is important to review these documents to ensure that the borrower is entering the mortgage loan with authorization and that the loan documents comply with any restrictions in the organizational documents and *vice versa*. The organizational documents may permit replacement of the managing equity holder of the borrower (the general partner, managing member or manager) with a non-managing equity holder following certain events. Such a possibility should be taken into account when drafting transfer restrictions in the loan documents and when considering the borrower's ability or willingness to file for bankruptcy in a distress scenario.

**Mortgaged Property**

In researching the mortgaged property, the lender should require the borrower to deliver an appraisal, all material leases, recent rent rolls, a property-condition report (sometimes called an engineering report or property-condition assessment), an environmental report, any management contracts relating to the mortgaged property, and evidence of property and liability insurance.

Rental income is usually the primary source of value and the most reliable cash flow for commercial property. The lender usually underwrites the rents on the basis of the rent rolls provided by the borrower. As part of its due diligence, the lender's counsel will have to review the leases and confirm that the information in the rent rolls matches the terms of the leases. To confirm that there are no undocumented modifications to the leases and that the factual information reflected in the rent rolls (*e.g.*, payment of rent) is correct, the lender should request that each (major) tenant provide an estoppel certificate confirming:

- that there are no further modifications to the lease
- that rent has been paid through a certain date
- the amount of the rent payable
- the remaining term of the lease
- the exercise of expansion options
- the absence of a default under the lease
- that the lease is in full force and effect.

While the security for the mortgage loan is typically a fee-simple interest in the subject property (*i.e.*, the ownership interest in the property), other interests in real estate may be mortgaged as well. For example, a developer may want to obtain land under a long-term ground lease rather than purchasing it. In such a case, the mortgaged property will consist of the developer's leasehold interest in the property, and the lender will have to make sure that the ground lease contains at least minimum protection for the lender against interference from the ground lessor (the owner of the property). Among other things, the lender should look for the right of the ground lessee (the borrower) to mortgage the interest without the ground lessor's consent, the right of the lender to foreclose on the mortgage and to transfer or assign the ground-lease interest without the consent of the ground lessor, and the right of the lender to enter into a new lease with the ground lessor in the event the lease is terminated prior to the end of its term.

The lender should obtain a title report for and a survey of the mortgaged property to determine the existence of any liens or interests in the property prior to the mortgage or that may affect the lender's interest. It will be a condition to closing that the lender receive an insurance policy from an acceptable title insurance policy insuring the first priority of the mortgage except for scheduled exceptions. A survey of the property with the proper notations from the surveyor can provide the lender comfort that the mortgaged property is in compliance with zoning requirements and building codes, contains the utilities required for operation, has access to public roadways and that any buildings located on the property do not encroach on another person's property. A zoning opinion or letter from the zoning authority will provide additional comfort as to zoning compliance.

The lender should also obtain evidence of the borrower's property and liability insurance to make sure that the mortgaged property is covered by adequate insurance and that the policies contain the standard lender protections. The property insurance policy should contain the Standard Mortgagee Clause (also known as Standard New York Mortgagee Clause) or Lender's Loss Payable Clause. These clauses identify the lender and will allow it to recover the proceeds under the policies even if the insurance company would not have released the proceeds to the borrower because of the borrower's acts. The commercial general liability insurance policy should list the lender as an "additional insured." In reviewing the insurance policies, the lender should also make sure the borrower has obtained coverage for any risks specific to the mortgaged property, such as terrorism, earthquake, flood or lost rents. These protections are not always included in the "Special Perils" or "Extended Coverage" forms of insurance regularly purchased by real property owners. Lenders should use insurance consultants to confirm the existence of required coverage.

Evidence of property and liability insurance is sometimes provided by the insurance company on industry forms (*e.g.*, ACORD certificates), in which case the accuracy of the certificates should be confirmed by reviewing the underlying insurance policies. The lender should not rely on the certificates as sole evidence of coverage. Also, the lender should require that any language in an insurance certificate stating that the certificate is provided "as a matter of information only" and "does not confer any rights on the certificate holder" be replaced with language confirming coverage. Certificate language stating that the insurance carrier will only "endeavor to mail" notice of early termination of the insurance to the certificate holder should be changed to an affirmative obligation to deliver such notice.

**Cash Flow and Values**

Since mortgage loans are typically non-recourse loans and are primarily secured by the mortgaged property, the lender has to make sure that the income from the property is sufficient to cover the debt service and other expenses of the property (*i.e.*, it must consider the debt-service coverage ratio). Also, the value of the property relative to the loan amount (the loan-to-value ratio) needs to be sufficient. If the lender is providing a mortgage loan for construction of a project and the mortgaged property is not yet producing income, the lender will want to review the construction plans to ensure that the project is well conceived. The construction costs (including hard, soft and acquisition costs) relative to the loan amount (the loan-to-cost ratio) should not exceed certain levels. The lender will want to review cash-flow projections (to make sure they are realistic) and ensure that the estimated value of the property as completed will be sufficient to cover and justify the cost of construction, considering comparable projects in the area. In the US, data on comparable sales, market rents, vacancy rates and other indicators for the relevant asset classes, real estate markets and sub-markets can typically be obtained from brokers and real estate research firms.

## Loan Applications, Term Sheets and Commitment Letters

The lender will typically provide a loan application or term sheet as a means of proposing the basic economic terms under which it would be willing to provide the mortgage loan. Once the borrower has accepted and countersigned the term sheet it will serve as the basis for the loan documentation and the bank's internal approval process.

**Binding *versus* Non-Binding**

The loan application or term sheet is typically drafted as a non-binding document that summarizes the basic business terms of the mortgage loan and it should expressly state that it is not binding on the lender. If a lender is willing to issue a binding commitment on the basis of the term sheet, it should have its attorney prepare a commitment letter describing the business terms and conditions of the mortgage loan in more detail. A lender will require a fee for the preparation of a loan application and typically a considerable fee to issue a binding commitment.

**Walking Away from a Commitment**

While a commitment is a binding obligation to fund the mortgage loan, it may include provisions permitting the lender to walk away under certain circumstances. For example, the commitment will typically not be open-ended and will expire if the loan is not documented or disbursed by a certain date. A lender may also reserve the right to terminate its commitment if a "material adverse change" occurs in the borrower's financial condition (a provision known as a "MAC clause"). In an uncertain pricing environment a lender may be willing to issue a binding commitment letter only on the condition that it retains the ability to adjust pricing if it is unable to syndicate the loan to other lenders on the original terms or if its cost of funds increases (a provision known as "market-flex" clause).

## Loan Documentation

When willing to provide the mortgage loan to the borrower, the lender will have counsel prepare the loan documents on the basis of the application, term sheet or commitment letter. The documentation will typically include a number of key documents.

### Note

The promissory note evidences the monetary obligation of the borrower to the lender and often sets forth, along with other terms, the interest rate, payment terms and maturity date.

### Loan Agreement

The loan agreement is usually the main loan document and will contain the key economic terms (loan amount, method for calculation of interest and interest rate, manner of payment, applicability of an alternative rate of interest in the case of LIBOR market disruptions (illegality or inability to determine LIBOR) provisions regarding reimbursement for certain increased funding costs caused by a change in reserve, liquidity, capital adequacy or other governmental requirements, prepayment penalties and breakage costs). Certain economic terms may be extracted from the loan agreement and dealt with in the promissory note. The loan agreement will also set forth the process by which the borrower may request advances (including conditions to such advances), amounts that must be maintained in reserve accounts, representations and warranties regarding the borrower and the mortgaged property, ongoing covenants of the borrower regarding its organization, property management and reporting, and the events of default permitting acceleration of the indebtedness and enforcement against the collateral. If the mortgage loan is held by multiple lenders, the loan agreement will typically include provisions defining the authority and duties of the agent, the lenders' consent rights regarding major lender decisions, the remedies available against a defaulting lender and restrictions regarding a transfer of a lender's interest in the loan.

The loan agreement includes both affirmative covenants, which create ongoing borrower obligations, and negative covenants, which prohibit the borrower from taking certain actions. Examples of affirmative covenants include maintenance of property and liability insurance policies, delivery of periodic financial statements and satisfaction of specified loan-to-value and debt-service ratios. Examples of negative covenants include prohibiting the transfer of the property or of ownership interests in the borrower, prohibiting additional debt and prohibiting material alterations to the property without the lender's consent.

The loan agreement (or the mortgage) will contain provisions governing the distribution of insurance proceeds and condemnation awards in the event of damage, destruction or condemnation of all or parts of the property. Typically, the lender will require that it receive directly all such proceeds and awards. However, if the damage or condemnation affecting the property does not exceed certain thresholds (*e.g.*, not more than 25 percent of the floor area of the building is destroyed or not more than 10 percent of the floor area of the building is affected by condemnation) or if the proceeds or awards do not exceed certain dollar thresholds, the loan documents will usually require the lender to make the proceeds or awards available to the borrower to rebuild the property.

The loan agreement should require the borrower to obtain the consent of the lender before taking actions with respect to the property that would affect the lender's assumptions in underwriting the loan. For instance, if the rents from the mortgaged property are the sole or an important source of revenue for debt service, the lender should require the borrower to obtain its consent before amending, terminating or entering into a lease that could (materially) affect this revenue stream. The lender is often willing to limit its consent right to major leases, usually defined as those involving space larger than a specified square footage.

**Mortgage or Deed of Trust**

The payment of interest, principal and other amounts due under the loan documents will be secured by a security interest in the property. Depending on the state where the mortgaged property is located, the security instrument of choice may be a "mortgage," or "deed of trust," or other instrument. In this chapter the term "mortgage" is used to describe all such security instruments. While a mortgage is a two-party agreement pursuant to which the owner of the property (the mortgagor) grants a security interest in the property to the lender (the mortgagee) as security for the repayment of the loan, a deed of trust is a three-party agreement. Under a deed of trust, the property owner (usually the borrower) conveys the property to a trustee (often a title company) who holds it for the benefit of the lender (the beneficiary). The key difference between a mortgage and a deed of trust is that the latter usually gives the lender the right, upon an event of default, to require the trustee to sell the property in a non-judicial foreclosure sale (the power of sale). While some states permit a mortgage to contain the grant of such a power of sale, most do not. Because a non-judicial foreclosure sale is typically much faster and cheaper than a judicial foreclosure, deeds of trust (or mortgages with a power of sale), where available, are the preferred security instrument for lenders.

Mortgages may secure future advances under term or revolving loans, but need to expressly say so in order for a future advance to be considered secured as of the date the mortgage instrument was recorded (and therefore to be afforded the priority of the recording date) rather than the disbursement date. Some states require the lender to have an affirmative obligation to fund future advances (so-called obligatory advances) for priority to relate back to the recording date of the mortgage instrument.

Another important provision within the mortgage is the "due-on-sale" or "due-on-encumbrance" clause, which allows the lender to accelerate the mortgage loan if the borrower sells or further encumbers the mortgaged property without the lender's consent.

The mortgage instrument will typically also grant the lender a security interest in the borrower's personal property and fixtures located on the mortgaged property. To perfect such a security interest, the lender needs to file a UCC-1 financing statement with the secretary of state where the borrower is organized and a UCC-1 fixture filing with the county clerk of the county where the mortgaged property is located.

**Assignment of Leases and Rents**

Even though the mortgage instrument will usually contain a grant of a security interest in the leases and rents derived from the mortgaged property, lenders will routinely require that a separate assignment of leases and rents be executed and recorded. These documents are drafted as an absolute assignment of the leases and rents to the lender with a license back to the borrower to collect the rents until an event of default has occurred.

**Assignment of Management Agreement and Subordination of Management Fees**

As additional security for a mortgage loan a lender will request an assignment of the property management agreement and subordination of the management fees. The assignment will permit the lender, at its option, to step into the shoes of the borrower upon an event of default to continue or terminate the management agreement. In the subordination portion of the assignment, the manager of the property agrees to subordinate its right to receive management fees and any resulting liens on the property to the lender's mortgage.

**Assignment of Contracts, Permits, *etc.***

Even though the mortgage usually contains a grant of a security interest in all contracts and permits regarding the property, the lender may request a separate assignment of contracts and permits.

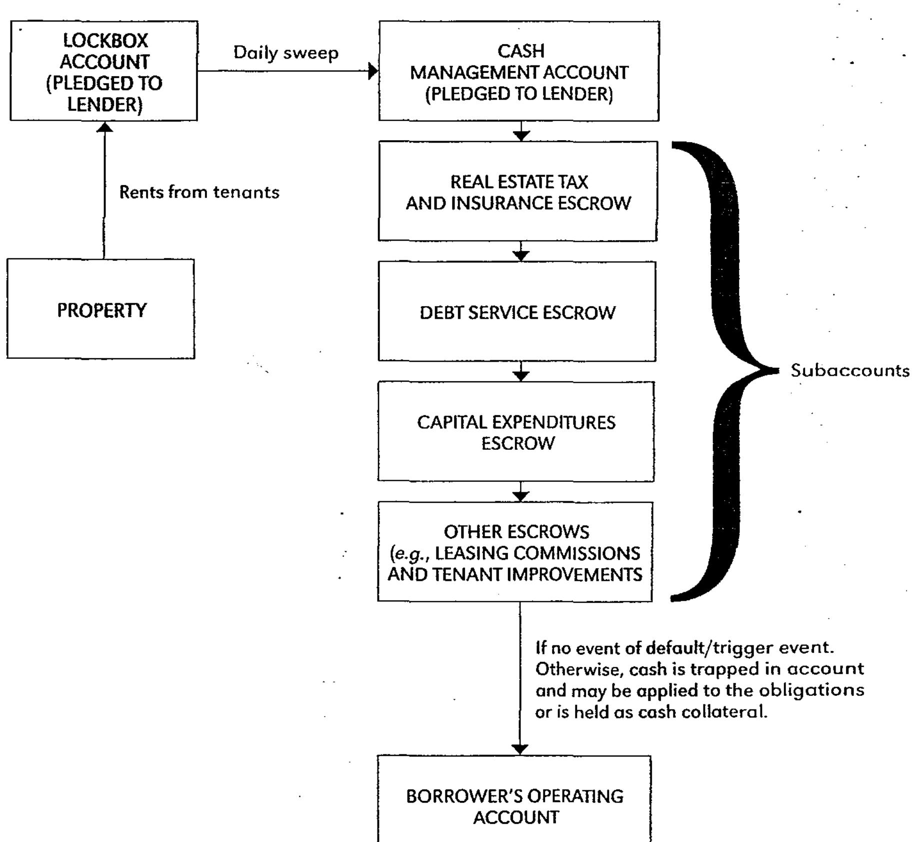
**Collateral Assignment of Interest-Rate-Protection Agreement**

If the lender requires the borrower to enter into an interest-rate-protection agreement in connection with the mortgage loan, it should also require the borrower to assign its rights under such agreement to the lender to permit the lender to demand that, following an event of default under the mortgage loan, all payments due by the counterparty to the borrower under the interest-rate-protection agreement are made directly to the lender.

**Cash Management**

Since rent payments are usually the primary source of income for payment of operating

EXHIBIT 1: CASH MANAGEMENT



expenses and debt service, lenders will want to set up a process by which they can monitor the rents and other income. The lender may require that the borrower open a "lockbox" account with a corresponding post office mailbox where tenants will send their rent checks. The lockbox bank will deposit the checks into the lockbox account, typically sweeping the funds to a separate cash-management account daily. Both the lockbox account and the cash management account will be pledged to the lender as additional security for the loan. Depending on whether this system is in effect from the outset or only upon a triggering event (*e.g.*, an event of default or financial covenant breach) and whether the borrower retains the right to make withdrawals from the accounts until the occurrence of a triggering event, such systems are referred to as "hard," "soft" or "springing" lockboxes. A hard lockbox may require that, provided no event of default or other cash-trapping event has occurred, the rents are first used to create real estate tax and insurance escrows, to pay debt service and operating expenses, and to create additional escrows before any funds are made available to the borrower. The loan agreement or a cash-management agreement will usually contain detailed provisions governing the payment streams. Separate account-control agreements will create and perfect the lender's security interest in the accounts.

**Guaranties**

As mentioned previously, commercial mortgage loans in the US usually permit the lender to proceed only against the property (not the borrower personally) upon an event of default. In an exception to the general non-recourse principle, lenders will typically require the borrower's ultimate equity owners or another credit-worthy entity in its chain of ownership to provide a personal non-recourse carve-out or "bad-boy" guaranty. Pursuant to these guaranties, the guarantors are personally liable for damages caused by their own or the borrower's "bad-boy acts" regarding the property. The list of bad acts triggering such personal liability is usually heavily negotiated but will typically include waste against the property, violation by the borrower or a related party of the transfer restrictions in the loan documents, fraud, the misappropriation of funds, and voluntary bankruptcy by the borrower or guarantor. Depending on the guaranty, the bad-boy acts may trigger personal liability for the damages caused by the bad-boy act or may result in the entire loan becoming full recourse to the guarantor (as is usually the case in the event of a voluntary bankruptcy filing).

The lender may also request a payment guaranty from a borrower-related party if necessary to underwrite the loan. Payment guaranties typically are capped at amounts less than the outstanding debt. Such guaranties may, for example, cover only "carry cost" (debt service and operating expenses) or scheduled amortization payments.

In construction loans, the lender will invariably require a completion guaranty from a creditworthy borrower-related party to guaranty lien-free completion of the project within a certain time if the borrower fails to do so. Such a guaranty should cover increases in construction costs (hard and soft) and may also obligate the guarantor to pay additional items such as debt service, insurance and real estate taxes through the date of completion if they are not paid by the borrower or covered by reserves.

**Environmental Indemnity**

Lenders routinely request the borrower (and also a creditworthy borrower-related party) to indemnify them against any claims resulting from a violation of environmental laws at the mortgaged property.

**Subordination, Non-Disturbance and Attornment Agreements (SNDAs)**

In the US, leases are governed by both real estate and contract law and create real estate interests in the property. As a result, leases in force prior to the recording of the mortgage are typically senior in priority to the mortgage. At a foreclosure sale, the property will be sold subject to the prior lease. Conversely, if the lease is entered into after recordation of the mortgage, the lease would be subordinate to the mortgage and upon a foreclosure, depending on the law of the state where the property is located, the lease may not survive the foreclosure sale. In order to protect valuable leases from automatic termination upon a foreclosure sale and to ensure first priority of its mortgage lien, a lender may condition its loan on receipt of so-called "subordination, non-disturbance and attornment agreements" (SNDAs) for major or valuable leases. Pursuant to the SNDA, the tenant will subordinate its leasehold interest to the lender's mortgage lien (subordination); the lender will, in turn, agree not to disturb the tenant's quiet possession of the leased premises so long as the tenant is in compliance with its obligations under the lease (non-disturbance); and the lender and tenant agree to accept each other as landlord and tenant, respectively, following a foreclosure (attornment). The lender will want to include in the SNDA that it will not be liable for landlord defaults that occur prior to a foreclosure or for construction obligations under the lease, that lease amendments will not be effective without the lender's consent, and that the tenant will give the lender the right to cure a landlord default under the lease.

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# Chapter 11

## REAL ESTATE FINANCE, PART II: THE BORROWER'S PERSPECTIVE

Phillip G. Levy and Barry D. Green, Goulston & Storrs, P.C.

### Construction Loan *versus* Permanent Loan

In general, real estate loans in the US are characterized as either construction loans or permanent loans. The proceeds of construction loans are used to construct or materially modify a project, whereas permanent loans are made once a project has been constructed and tenants are in place. Construction loans tend to have short terms (one to two years, depending upon the time anticipated to complete and lease up the property) and permanent loans longer terms (typically five, 10, 15 or even 20 years). Interest rates on construction loans tend to float, often based on a spread over the prime rate or LIBOR, while permanent loans tend to bear fixed rates. Construction loans tend to require interest-only payments (with no principal payments required), while permanent loans tend to require principal amortization. Historically, banks focused their real estate lending on construction loans — in part because their short-term, floating-rate deposit base lent itself to shorter-term, floating-rate lending. The permanent-loan arena was dominated by life insurance companies and pension funds, whose long-term financial horizon matched well with long-term fixed-rate real estate lending. For many years, some banks have offered a "mini perm" option on selected construction loans, where the borrower would be allowed — upon completion of construction and achievement of certain leasing and debt service coverage — to "convert" the construction loan into a permanent loan that would last for a few years.

More recently, this division has become blurred and a new group of lenders has emerged, including Wall Street investment banks and non-bank finance companies. Banks have participated actively in the long-term permanent loan market — particularly through the securitization process. Some life insurance companies have offered construction-loan facilities that would convert into long-term permanent mortgage loans. Time will tell whether the unraveling of the conduit market will push US real estate lenders back into their historic areas of focus.

## The Process

### Identifying a Lender

The first step for a real estate borrower is to identify the lender. For construction loans, a foreign investor should work with its US-based colleagues (local development partners, brokers or attorneys) to identify active construction lenders in the specific market. For permanent loans, the same resources can be utilized to identify lenders who might be approached to give a quote for a potential permanent loan. There are also a number of companies that act as mortgage brokers to assist borrowers in identifying potential lenders — particularly in the permanent-loan arena. It is common for a borrower to obtain rate and term quotes from several lenders before choosing one. If the loan is a large one, the lead lender may need to identify additional lenders to participate in the loan (either as participants or as co-lenders — see page 83).

### Term Sheet *versus* Loan Commitment

Once a lender has been identified, it typically generates a term sheet or loan commitment setting forth the principal terms of the arrangement under negotiation. A term sheet is typically very short (one to two pages) and simply sets forth the most fundamental business terms of the loan being offered. A term sheet would typically identify the borrower, the property, the amount and term of the loan, the interest rate, the fees payable to the lender and the collateral. By its terms, a term sheet typically is not binding upon the lender. The loan commitment is at the other end of the spectrum, running as long as 30 pages and often including many fully-negotiated provisions of specific interest to the lender or the borrower. Often, a loan commitment is styled as a binding obligation of the lender to fund the loan upon the satisfaction of the conditions to closing set forth in the loan commitment (although in practice, lenders typically include language that significantly undercuts the binding nature of the loan commitment).

Lenders tend to have their own internal approaches to documenting loans at this stage, so it would be difficult for a borrower to convince a lender accustomed to working from a term sheet to generate a lengthy and detailed loan commitment (and *vice versa*). However, if the more general term-sheet approach is taken, it would be wise for the borrower to identify and flesh out any issues of importance that are not addressed. Similarly, if a detailed loan commitment is utilized, the borrower would be well advised to negotiate it in detail. Occasionally, borrowers are tempted to move beyond the loan commitment to the loan document stage as quickly as possible, choosing not to negotiate the loan commitment in detail in the mistaken belief that issues there can be corrected through negotiation of the actual loan documents. Such borrowers typically find, however, that the lenders are unable or unwilling to revise the terms set forth in the loan commitment. Once the term sheet or loan commitment has been negotiated, the loan officer will present the loan to the lender's internal loan committee for approval. Typically, the loan will be approved on the terms set forth at this stage. On occasion, however, the loan committee will revise important terms or impose additional obligations on the borrower.

At some point in this process, the borrower will be expected to sign the term sheet or the loan commitment and to pay a loan application fee sufficient to pay for the bank's underwriting process (appraisal, inspection, environmental review, *etc.*). The loan committee's approval does not mean that all conditions to closing have been satisfied. Either through its own internal resources or by hiring outside experts, the lender typically will review the borrower's financial status, the physical condition of the property (including its compliance with applicable environmental laws) and the leases, title and survey. The bulk of this analysis takes place after loan committee approval but prior to closing.

### Participating Lenders, Co-Lenders and Conduit Lenders

Larger loans often require more than one lender. The conduit market has made this process very efficient by allowing the originating lender to sell the portion of the loan it did not wish to retain through the Real Estate Mortgage Investment Conduit (REMIC) process. Since at present the conduit market is essentially "closed for business," lenders are likely to revert to the traditional method of "co-lender" or "participant" relationships. In a participation structure, the lead lender retains all contractual rights and obligations specified under the loan documents, but has an agreement with each participant lender with respect to a portion of the loan. In the co-lender structure, each co-lender becomes a party to the loan documents and has a direct contractual relationship with the borrower. Each lender is directly responsible to the borrower to fund its share of the loan advance, and the lead lender acts as agent on behalf of itself and the other lenders in administering the loan. A co-lender arrangement means that the borrower may need to deal with multiple lenders in such matters as negotiating the loan documents or obtaining lender consents that may be required under the loan documents. In the case of a construction loan, the borrower must also be comfortable that each co-lender will be capable of meeting its obligations for future advances. It is therefore advisable for the borrower to insist that potential co-lenders meet some financial standards.

### Loan Documents

The principal loan documents in a commercial real estate loan in the US typically include the following:

- the promissory note, which contains the promise to pay and sets forth the basic terms of the loan
- the loan agreement, which sets forth the borrower's representations and warranties, the conditions to closing, the conditions (if any) to further loan advances, the terms of any ongoing financial covenants, reporting obligations and events of default
- the mortgage, which creates a lien on the real property and associated personal property
- the collateral assignment of leases, which provides the lender with a security interest in the current and future leases on the property
- an environmental indemnity, pursuant to which the borrower (and often a separate creditworthy guarantor affiliated with the borrower) agrees to indemnify the lender for losses incurred as a result of the current or future presence on the property of oil or other hazardous materials
- Uniform Commercial Code financing statements, which are necessary to perfect the lender's lien on certain personal property
- a "non-recourse carve-out guaranty," signed by a creditworthy guarantor affiliated with the borrower, protecting the lender against losses resulting from any "bad acts" of the borrower; the scope of this document is typically the subject of extensive negotiation.

In the case of construction loans, numerous other closing requirements and loan documents are required to allow the lender to step into the borrower's shoes if a default occurs and to complete construction of the project. Accordingly, collateral assignments of the architect's, engineer's and construction contracts are typically required. In addition, it is not uncommon for a construction lender to require a completion guaranty from a creditworthy party affiliated with the borrower, as well as a payment guaranty for interest, carrying costs and at least a portion of the loan principal.

### The Closing Process

Once the term sheet or loan commitment has been approved by the lender, its legal counsel will typically generate a closing checklist of the documents to be delivered and other requirements to be satisfied in order to close the loan. The lender's counsel will also generate draft loan documents incorporating the terms of the term sheet or loan commitment. The borrower and its counsel review the loan documents to make sure they are consistent with the term sheet or loan commitment, and check for other issues of concern. Once the loan documents have been fully negotiated and the closing conditions satisfied, the loan documents will be executed and delivered and the loan proceeds (or, in the case of a construction loan, the initial advance) will be funded. Closings of commercial real estate loans in the US typically occur by mail, often using the title insurance company as escrow agent.

## Major Borrower Issues in Permanent Loan Documents

An exhaustive discussion of borrower issues in real estate loan documents is beyond the scope of this article, but a brief description of some of the major issues on which borrowers typically focus is set forth below.

### Promissory Note

Besides confirming that the basic business terms of the loan have been properly incorporated in the promissory note, the borrower will want to understand whether prepayment or defeasance is permissible and what penalty or payment obligations such a prepayment will entail.

### Non-Recourse Carve-Out Guaranty

The terms of this guaranty are typically heavily negotiated. A borrower will want its liability for a breach of the non-recourse carve-out provisions to be limited to the lender's actual loss resulting from such a breach. Lenders sometimes seek to treat a breach of the non-recourse carve-out provisions as a "trigger event" causing the guaranty to require a full payment. In addition, the scope of the non-recourse carve-outs themselves is negotiated. A borrower will want to define the term misapplication of revenues so that distributions made at a time when no event of default exists are not subject to clawback by the lender. Similarly, the borrower will want to make clear that its liability for payment of taxes and insurance is contingent on there being sufficient revenue from the property for that purpose. Lenders sometimes will want the guarantor to guaranty payment of insurance and taxes regardless of the sufficiency of revenues from the property.

### Loan Agreement

#### *Leasing*

The borrower will often seek to define a minor lease based on square footage or rental income, so that it can enter into, amend and terminate such leases without the lender's consent. For leases over any such threshold, the borrower will want the lender to agree that it will not unreasonably withhold its consent, and that its approval will be deemed to have been given if a specified period (such as 20 days) passes without the lender responding to a request from the borrower for approval.

#### *Site Plan Changes*

If the borrower knows that it may construct additional improvements on the property or might seek a partial release of a portion of the mortgaged premises, it would be wise to negotiate provisions into the loan agreement to specify the terms under which the lender must approve such changes.

#### *Financial Covenants*

If the loan includes a loan-to-value test or debt-service-coverage test, the borrower will want to limit the number of times such tests are administered, and will want to make sure that the terms defining the test are clear. A borrower will often ask for the right to cure a breach of financial covenants of this type, either by partially paying down the loan or by posting additional collateral acceptable to the lender. If the property has recently been completed or renovated, the borrower may need to have the initial debt-service-coverage test use projected income from signed leases (as opposed to historic income from tenants in occupancy).

#### *Events of Default*

For monetary defaults (other than regular monthly payments of interest and principal), a borrower will want written notice and an opportunity to cure. For most other defaults, the borrower will want a

30-day cure period, with the right to extend the cure period if the borrower has commenced and is diligently prosecuting the cure to completion. The lender may seek to cap the extended cure period. The lender is likely to specify certain defaults (such as a failure to carry insurance, violation of the transfer restrictions, violation of single-purpose covenants) as having no cure period.

### *Financial Reporting*

The borrower will want to ensure that provisions calling for monthly, quarterly and annual property-related and financial reporting are sensible and consistent with its ability to produce information and reports.

### *Permitted Transfers*

The borrower will want to allow for a certain level of transfers of interests between parties other than general partners and managing members without the lender's consent. In addition, the borrower will want to allow for transfers among existing partners (particularly if there is a buy/sell provision in its operating agreement). A foreign investor which has partnered with an operating partner will want to make sure that the loan documents do not prohibit it from exercising its rights under the joint-venture agreement to replace the operating partner as managing member or general partner. Typically, lenders are receptive to requests for transfer rights to family members, estate-planning trusts and the like where the principal maintains operational control of the interest.

### *Additional Debt*

If the borrower anticipates placing subordinate mortgage debt or mezzanine debt on the property, it should negotiate those rights into the loan documents up front.

### *Insurance Proceeds*

The lender's generic loan documents often will not require it to release insurance proceeds to the borrower in the event of a casualty. Borrowers typically can negotiate for the release of insurance proceeds without conditions, in amounts below some threshold amount usually related to the size of the property, and if certain conditions are satisfied in the event of a larger casualty. Such conditions might include those typical in construction loans.

### Environmental Indemnity

Over the past several years, borrowers have often been able to avoid delivering an environmental indemnity, sometimes by purchasing environmental insurance. It is unclear whether lenders will continue to accept environmental insurance policies in lieu of indemnification agreements. In any event, borrowers and indemnitors will want to negotiate indemnification agreements to ensure that they cover only hazardous-waste and environmental requirements and not a broader range of land-use regulations; that they include a sunset provision so that the indemnitor is not responsible for releases which occur after the borrower is in control of the property following foreclosure or lender's acceptance of a deed in lieu of foreclosure, for example; that the indemnification does not run to a third-party purchaser at foreclosure; and that the borrower would not be in default merely by virtue of a new release of hazardous waste on the property, as long as the borrower is investigating and remediating the release in accordance with applicable law.

## Major Borrower Issues in a Construction Loan

Many of the issues set forth above would also be addressed in construction loan documents. In addition, a number of provisions unique to construction loan documents are of interest to the borrower. These include the following.

### Project Budget

The borrower will want language in the construction loan agreement to allow it to reallocate savings from one budget line item to cover cost overruns in other line items. The lender will typically allow this, provided the borrower demonstrates that the savings have actually been realized. In addition, the borrower will want the right to access a contingency line item, whereas the lender's documents often give the lender absolute control over the use of the contingency line item. It is not uncommon for a lender to agree to allow a borrower access to the contingency line item in proportion to the percentage of completion of the project.

**Completion Guaranty**

The guarantor will want a clear definition of the conditions for release of the guaranty. For example, if leases require the tenants to complete their own improvements, the developer would want the definition of completion to exclude such tenant improvements. Similarly, in some jurisdictions, a final certificate of occupancy is not issued until all space in the project has been built out and occupied, and occupancy under a temporary certificate of occupancy is customary until that point. In such an instance, the guarantor would not want the loan agreement's definition of completion to require issuance of a final certificate of occupancy. The guarantor would want the guaranty to be drafted so that it is responsible only for the difference between the actual cost to complete and the unadvanced loan amount. Without such a provision, the lender could cease funding upon the occurrence of an event of default, and then look to the guarantor to fully complete the project (or to reimburse the lender for its costs of completion) without taking into account the unadvanced loan proceeds.

**Conditions to Conversion**

If the loan has a "mini-perm" feature following completion of construction, the borrower will want to make sure that the conditions for exercising the extension are clearly defined. In particular, a debt-service-coverage test administered at loan conversion should be applied using projected income from signed leases (as opposed to looking backward at historic revenues).

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# Chapter 12

## REAL ESTATE FINANCE, PART III: MEZZANINE LOANS

Gary A. Goodman and David A. Viklund, Sonnenschein Nath & Rosenthal LLP

Between the mid-1990s and the end of the latest real estate boom, CMBS grew to become a dominant force in commercial real estate finance, competition among lenders fueled borrowers' appetites for loan proceeds, and increased loan-to-value ratios prompted lenders to create subordinate tranches of debt in a manner acceptable to the rating agencies. Historically, subordinate financing of commercial property had been secured by second mortgages. Since the rating agencies and investors in CMBS did not look favorably upon the possibility of other secured creditors being involved in the event of bankruptcy of the mortgage borrower, the mezzanine loan, not directly secured by the mortgaged property, became the predominant method through which lenders provided subordinate indebtedness to borrowers.

A real estate borrower does not typically seek multiple layers of debt. After a "pricing and proceeds" conversation with its CMBS lender, however, the borrower will usually capitulate and agree to form multiple entities and execute multiple sets of loan documents to achieve the desired pricing and proceeds. Interest rates on the mortgage loan and mezzanine loans are combined in a blended rate to which the borrower agrees.

When the mortgage-backed securities did not attract the anticipated price, the lender would require the mortgage borrower to amend the loan (already closed) to split off one or more mezzanine pieces. Standard CMBS loan documentation reserves in the lender the right to create layers of mezzanine debt after closing so long as the blended interest rate does not increase.

Since the mortgage loan would become part of a large pool of loans deposited in a securitization, mezzanine loans were sold separately to institutional buyers. Thereafter, the borrower would have relationships with lenders with both direct and indirect interests in its property.

### Loan and Borrower Structure

The mezzanine loan is wholly independent from the mortgage loan and subject to its own documents. Mezzanine loan documents typically mirror mortgage loan documents, except that the security is a pledge of equity in the mortgage borrower rather than a mortgage upon the borrower's real property (see Exhibit 1 below).

A simple mortgage/mezzanine borrower structure (see Exhibit 2) involves a mortgage loan to a special-purpose, limited liability company or limited partnership created solely in order to hold title to the underlying property. The member(s) or limited partner(s) of the mortgage borrower would enter into a second loan, typically with the same lender secured by a pledge of the mezzanine borrower's ownership interests in the mortgage borrower (or in the case of a limited partnership, by a pledge of the equity in the mortgage borrower's general partner). The preferred structure involved two single-member Delaware limited liability companies acting as mortgage loan borrower and mezzanine loan borrower. Each entity would have a "springing member" (either a person or an entity) that would become a member of the single-member limited liability company in the event of the dissolution of its sole member.

Additional tiers of mezzanine borrower entities would be added for each layer, or tranche, of mezzanine loans in a given transaction.

### Documentation and Remedies

As both are non-recourse loans, the documentation of a mezzanine loan for the most part is very similar to that of a mortgage loan. The mezzanine borrower executes a promissory note in favor of the mezzanine lender in the amount of the mezzanine loan; they enter into a loan agreement containing the terms of the loan, non-recourse carve-out guarantees are executed by the principals of the mezzanine borrower, and the ancillary documentation, certificates and legal opinions are similar to those familiar to mortgage loan borrowers. The mezzanine loan documents are typically prepared after the mortgage loan documents have been substantially negotiated, as the representations and loan covenants generally mirror the mortgage loan documents (except that the representations and covenants applicable to the mortgage borrower will be made separately by the mezzanine borrower as the

EXHIBIT 1: INVESTMENT STYLES – A RISK/RETURN APPROACH

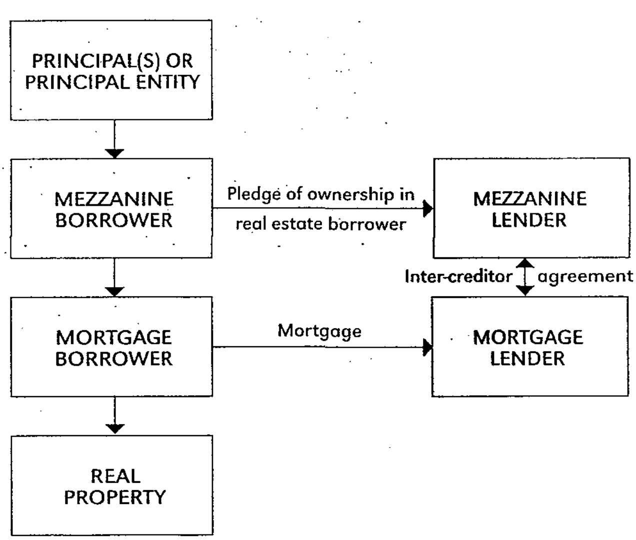
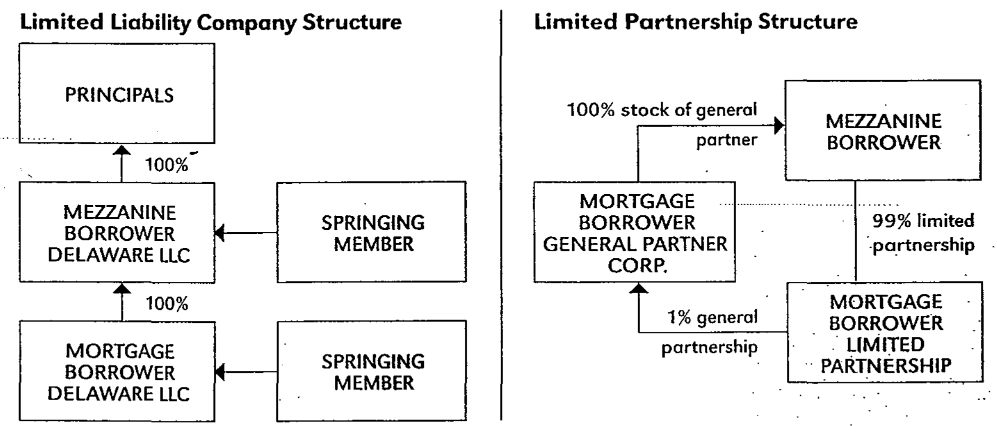


EXHIBIT 2




parent entity that controls the mortgage borrower). An event of default under the mortgage loan is always an event of default under the mezzanine loan documents; an event of default under the mezzanine loan documents is never an event of default under the mortgage loan documents unless the circumstance giving rise to the mezzanine loan default is also an event of default under the mortgage loan documents.

The primary distinction between mortgage and mezzanine documentation is that the mortgage is replaced by a pledge and security agreement. The lender's collateral is not a mortgage, deed of trust or similar instrument secured by the borrower's real property but a pledge and security agreement granting to the mezzanine lender a security interest in the mezzanine borrower's equity interest in the mortgage borrower. The mezzanine lender's security is not an interest in real property but one in personal property governed by Article 9 of the Uniform Commercial Code (the UCC). A mezzanine lender perfects its security interest in its equity collateral either by filing a Form UCC-1 financing statement with the secretary of state of the state in which the mortgage borrower is formed or by requiring the mortgage borrower to execute the blank equity interest (this "certification" is also referred to as "opting-in" to Article 8 of the UCC) certificate provided by the mezzanine borrower. In practice, many mezzanine lenders will do both.

In the event of a default under the mezzanine loan documents, the mezzanine lender's remedy is to foreclose upon its security interest in the mortgage borrower pursuant to Article 9, Part 6 of the UCC. Especially in states that require judicial foreclosure of mortgages, which can easily take over a year, a UCC foreclosure can be completed in as little as 30–45 days.

### The Inter-Creditor Agreement

The mortgage lender and the mezzanine lender enter an inter-creditor agreement, although it rarely involves any input from either the mortgage borrower or the mezzanine borrower. Though typically kept confidential by the lenders, this agreement often is the most heavily negotiated and important document to the mezzanine lender. Since most mortgage loan documents restrict transfers of ownership interests in the mortgage borrower and since foreclosure of a mortgage would leave the mezzanine lender without any underlying collateral, the inter-creditor agreement governs, among other things, the circumstances and terms upon which the mezzanine lender may cure defaults under the mortgage loan documents, exercise its remedies under the mezzanine loan documents, become the owner of the mortgage borrower and, in certain circumstances, purchase the mortgage from the mortgage lender. Other key provisions relate to the mezzanine lender's ability to transfer the loan (usually limited to a defined universe of "qualified transferees"), participate in decisions regarding the operation of the underlying real property (such as lease approvals, budget approvals and the like) and, where there is more than one tier of mezzanine debt, which mezzanine lender is the "directing" or "controlling" lender with respect to decisions affecting the mezzanine lender group as a whole (other provisions set forth the circumstances upon which the directing or controlling mezzanine lender would lose such status — usually through a decline in the value of the underlying real estate asset, which could result in the more subordinate tranches of debt being "appraised out" of control).

### Drawbacks to the Borrower

While few borrowers object to the increased loan proceeds made available through the use of mezzanine loans, there are a number of drawbacks to the product.

First, the additional tiers of indebtedness substantially increase the costs of closing. Creating multiple sets of documents even substantially similar documents, can increase legal fees significantly. Negotiating pledges of equity interests, conforming organizational documents to the requirements of the UCC, negotiating mezzanine cash management agreements, and obtaining separate sets of legal opinions for the mortgage loan and each tier of mezzanine debt further increase legal fees. The borrower must establish and maintain multiple tiers of bank accounts and is often required to obtain a "mezzanine endorsement" to its owner's title insurance policy (particularly if the loan is in connection with the acquisition of the relevant property) and is always required to obtain a "UCC Policy" insuring the attachment, perfection and priority of the lien of the mezzanine lender in its equity collateral.

Second, multiple lenders means the borrower will have to obtain multiple consents when operating activity requires lender consent. In order to enter into or modify a major lease, obtain approval of an annual budget or perform relatively minor alterations to the property, a borrower must deal with both mortgage and mezzanine lenders or servicers. Further, it is the standard that the borrower will not request consent from the mortgage loan servicer until it has already received consent from the mezzanine lender(s).

Additionally, while the originating lender and the borrower may have a substantial history of doing business together, the CMBS/mezzanine arrangement is the antithesis of relationship lending. Once the loans have been closed, the originating lender's goal is to distribute all parts of them as quickly as possible. After distribution, the originating lender usually will have little or no retained interest in the loans and the borrower will be left dealing with servicers and institutions with whom it may have no relationship whatsoever. While master servicer/special servicer relationships in securitized mortgages are familiar to most borrowers, the buyer of a mezzanine loan may be an institution looking simply to be paid the increased spread, or it may be a competitor willing to own the asset if the borrower defaults in its obligations. Often the most subordinate tranche of debt is purchased by the losing bidder who believes the borrower overpaid but that the underlying property is worth the amount of the senior debt plus the value of its position in the debt stack.

When a property subject to mezzanine financing becomes distressed, the borrower may have a much more limited ability to work out problems with its lender than when only mortgage-level debt is in place. While CMBS special servicers and balance-sheet mortgage lenders may be willing to work with a borrower to avoid having to foreclose upon their mortgage (a drawn-out process), a mezzanine lender may commence enforcement remedies quickly, and many are willing to take ownership of a borrower's property. These factors can lead to asset loss on a very expedited schedule.

## The Credit Crisis

During the credit crisis but before September 15, 2008, although CMBS lenders had completely ceased new originations of mortgage loans, certain balance-sheet lenders (primarily insurance companies and German banks) continued lending, although on very conservative terms. In order to bridge the gap between the 50 or 60 percent of value granted by such lenders and borrower equity, some true third-party mezzanine debt was provided by real estate funds. Such financing typically provided an additional 10 to 15 percent (bringing aggregate loan-to-value into the range of 60 to 75 percent). Although not replacing the volume formerly generated by CMBS lenders, many in this line of business thought the model would be a significant source of capital to the real estate industry. Displaced CMBS executives, among others, raised hundreds of millions of dollars to create "mezzanine funds" designed to make loans and to purchase distressed mezzanine loans in the secondary market. Lehman Brothers' bankruptcy, among many other things, essentially brought to an end all real estate lending for the balance of 2008, with barely a trickle resuming in the beginning of 2009.

According to *The Wall Street Journal*, there is $50 to $75 billion in mezzanine debt outstanding, investors in which are "suffering a massive casualty rate," and trying to "salvage some of their loans." At the same time, they are trying to avoid forfeiting their portfolios to warehouse line lenders,[1] many of them are the banks that sold the mezzanine loans in the first place. Deutsche Bank analysts estimate that commercial property values will decline by 35 to 45 percent from 2007 highs and that, of $154.5 billion of CMBS mortgages maturing between now and 2012, about two-thirds will not qualify for refinancing.[2]

With the real estate finance markets still in deep-freeze and the extent of commercial real estate losses from the credit crisis and the resulting recession only beginning to be realized, it is hard to predict how and when the real estate industry will rebound and what type of financing will be available. It seems reasonable to assume that loan-to-value ratios for mortgages will be significantly reduced from recent levels. As long as debt is cheaper than equity, most borrowers will seek to maximize leverage. With the tremendous amount of capital raised and held by mezzanine funds and private-equity funds, one can only assume that mezzanine lending will commence again along with mortgage finance.

[1] *The Wall Street Journal*, "Mezzanine Debt Loses Its Shine with Investors," February 18, 2009.

[2] *The Wall Street Journal*, "Commercial Property Faces Crisis," March 26, 2009.

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Gary Goodman, chair of the Sonnenschein New York real estate practice, has extensive experience with all types of real estate transactions: complex lending and leasing transactions, including office, retail and industrial; long-term leasing, net and ground leases, representation of institutional lenders and borrowers in fee and leasehold financings, re-financings, workouts and sale-leasebacks; international investment in real estate; creative real estate-related financing vehicles; and securitized financings and representation of owners of office buildings and shopping centers.

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# Chapter 13

## COMMINGLED FUNDS, PART I: OVERVIEW OF FUND TYPES AND STRATEGIES

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In addition to direct property investments and joint ventures with real estate operating companies, foreign investors may elect to invest in commingled funds focused on real estate to further diversify their portfolios. Such funds, which are pooled interests in a portfolio of assets, were originally created in the 1970s and focused on core properties. These early funds, while successful, had open-end structures and encountered valuation and liquidity challenges during the late 1980's market downturn. In order to better adapt to market volatility and avoid structural issues inherent in the open-end fund model, investment managers created a new generation of funds, mirroring the private equity model. Consequently, the commingled fund business has expanded to more than 1,500 real estate funds globally, managing gross assets in excess of $580 billion[1] and has become a staple of diversified investment programs, increasing its significance as a source of capital for the real estate industry.

By investing in commingled funds, investors, or limited partners, assume a passive role and authorize a professional real estate fiduciary to make investment decisions and assemble portfolios on their behalf. In most cases, commingled funds share the following characteristics:

- Their common objective is to invest capital in multiple assets, create value by growing cash flows and dispose of assets at a profit.
- They are managed by a sponsor who maintains full discretion over investment decisions and operation of the assets, based on predetermined objectives.
- They are structured either as infinite-life, open-end funds or as finite-life, closed-end funds with standard terms ranging between six and 10 years (subject to extensions for optimal disposition).
- They are comprised of capital contributions from various types of investors — sovereign wealth funds, endowments and foundations, public and private pension funds, and high-net-worth families or individuals.

[1] Preqin as of May 7, 2009; includes all existing funds closed since 2002.

Ultimately, commingled funds offer value by enabling a symbiotic relationship between stakeholders. The limited partners, who provide investable capital, seek diversification and attractive risk-adjusted returns but often lack the resources necessary to efficiently deploy capital. The general partners, having developed specialized expertise, provide skilled investment management in exchange for a share of the profits.

## Fund Structures

Real estate investments are typically illiquid and difficult to value and thus well suited for private investment vehicles. Both open-end and closed-end structures offer the efficiency of sponsor discretion and portfolio diversification, but differ in duration of investor commitment. Open-end funds have no fixed maturity period and are designed for the issuance and redemption of ownership interests at any time, allowing for continuous entry and exit of investors, while closed-end funds initiate and complete their investment activities within a defined period, returning capital only upon realization of investments. The majority of commingled vehicles are privately held, owing to the relative ease of formation; however, funds may also be listed and traded on a stock exchange. Such listed funds offer enhanced liquidity but experience greater volatility as they are more immediately impacted by external forces than their private counterparts.

### Closed-End Funds

Most real estate private equity vehicles are closed-end, primarily due to transmittal investment strategies and the attractive alignment of stakeholder interests. Closed-end funds offer a limited number of shareholder interests and a finite life, typically six to 10 years, during which investment managers must acquire, enhance, manage and harvest their assets. Closed-end funds are best suited to hold investments that require significant operational improvements or adaptive reuse, as value during the renovation period is difficult to accurately gauge. While the investments' values will ultimately be realized through disposition, the value of the fund's assets are incrementally marked-to-market, although in a manner that yields less volatility than that of the daily fluctuations of listed markets. By restricting the acceptance of new investors to an initial commitment period, the closed-end fund model provides the sponsor confidence in its supply of capital.

### Open-End Funds

An open-end fund is an investment vehicle with an unlimited life that funds its operations through property-level cash-flow generation, asset sales and additional equity offerings. Unlike closed-end funds, which are typically blind-pool, investors in open-end investment vehicles fund their commitments into a specified portfolio of assets. These funds offer liquidity through redemption provisions based on the fund's net asset value (NAV), which represents the marked-to-market value of the underlying assets, adjusted quarterly, and in some cases daily. While liquidity is dependent on the fund's available cash reserves and injections of capital from new investors, open-end funds are permitted to liquidate investments to meet withdrawal requests.

## Investment Strategies

The complexity of executing multiple investment strategies, coupled with inefficiencies in the acquisition and operation of real estate, requires specialization and active management by experienced managers to successfully create value. Moreover, identifying undervalued and under-managed properties poses significant hurdles as opportunities may arise due to evolving economic conditions as well as specific underlying property fundamentals. Value creation depends largely on the detailed understanding of many variables, including property type, market trends and geographic considerations. As such, experts gain a substantial edge derived from their greater focus on the unique dynamics associated with particular investment opportunities, which leads to more informed acquisition, disposition and management decisions. Through thoughtful establishment of the investment strategy, careful asset selection and active operational management, sponsors seek to generate attractive risk-adjusted investment returns.

Commingled funds are typically arranged around a dedicated investment strategy and are categorized by the type of asset, return expectations and risk tolerance targeted by the investment manger and its investors. The primary categories of funds are discussed below.

**Core Investing**

A core strategy seeks to invest in diversified portfolios of traditional real estate asset types (office, retail, industrial and multifamily) that are well occupied and where the income stream from rent collections represents a significant portion of the expected total return. Such strategies focus on properties with long-term, stabilized cash flows and modest leverage (up to 30 percent), seeking to safely earn returns above inflation with a limited exposure to risk. The expected return profile of a core fund is typically 7 to 9 percent.

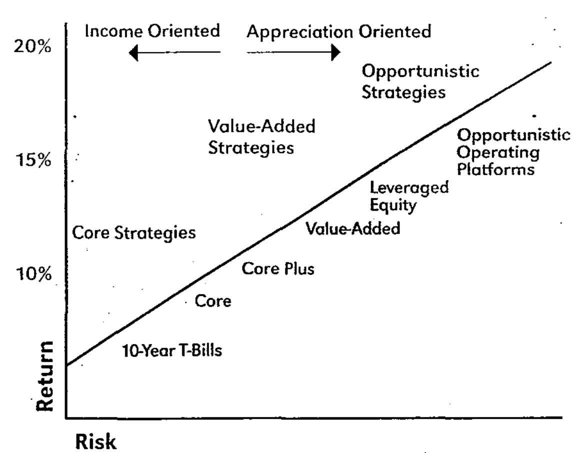
**Value-Added Investing**

Value-added investing is a strategy of moderate risk/return that seeks to acquire assets and increase operating income or make significant capital improvements to enhance value. These investors employ up to 70 percent leverage and create value through land and building development or redevelopment, re-leasing or re-tenanting, repositioning and management improvements. Unlike core investing, a significant portion of the expected total net return of 10 to 15 percent (16 to 18 percent gross) is derived from the appreciation of the underlying asset.

**Opportunistic Investing**

Opportunistic investing targets higher risk investments, with commensurately higher return expectations, where the return is generated almost entirely from residual value (limited current income). The objective is to create value through capital appreciation by targeting undervalued assets or taking risks associated with land improvement or new development. Unlike lower-risk strategies where current income is a component of the overall return, opportunistic investing involves enduring considerable market volatility risk which, over a multiple-year hold

EXHIBIT 1: INVESTMENT STRATEGIES: RISK *VS.* RETURN



period, may significantly impact the value of the property. Thus, opportunistic investment requires significant initial capital expenditure with little or no current income realizations. These funds typically target gross returns to investors of 20 percent or more, are often global or international in scope, and may be focused on both emerging and established markets.

**Debt-Focused Funds**

Debt plays a significant diversifying role in institutional portfolios, providing steady, reliable streams of cash to investors. Additionally, due to its seniority over equity positions within the capital structure, debt provides a cushion against declines in equity value during economic downturns. Debt strategies range from those targeting the most senior, secure tranche of the capital stack to those focused on mezzanine and high yield credit, with each level exhibiting a higher risk profile. Fund managers seeking to enhance returns often focus on originating or purchasing lower quality issues where risk tolerance and superior underwriting can be used as a competitive advantage. In leveraged capital structures, high yield debt occupies a position between senior debt (bank lending) and equity capital, and because only a thin layer of equity protects this subordinated debt from impairment, managers seek to earn substantial margins over higher quality alternatives. By embracing credit risk and introducing equity characteristics into the expected payment streams, managers seek outsized returns not only from a higher interest rate charged to the borrower, but also from a combination of equity participation and or purchase discounts.

**Funds of Funds**

Fund of funds managers select investment funds on behalf of their limited partners. By pooling commitments, usually from smaller investors, these sponsors provide economies of scale and focus on manager selection and performance monitoring functions that smaller limited partners are unable to easily replicate. Funds of funds also offer larger institutions the ability to gain exposure to unfamiliar market niches and emerging managers. Strategies pursued by these funds range in scope from globally diversified to specific niche strategies.

**Secondary Funds**

Changes in the value of a portfolio's underlying assets often require a diligent portfolio manager to rebalance, often through the disposal of limited partnership interests in overweight sectors. However, the absence of a liquid market coupled with uncertain valuations can impede the disposal of such interests, and as such, secondary fund managers have emerged as specialists in evaluating and acquiring these interests. Secondary buyers target these opportunities as a means to access skilled managers at a discount (although in rising markets such opportunities may command a premium) and funds which offer increased transparency through their existing investments.

**Sector-Focused Funds**

In addition to the investment strategies discussed above, commingled funds are often further focused on a specific geographic area and or property type, or on a specific asset class such as hospitality, retail, residential, storage, senior living, industrial or office. One of the advantages of the commingled fund format is its flexibility in allowing fund managers to select strategies that capitalize on specific opportunities.

## Compensation and Alignment

Appropriate organizational structure is a critical element of successful partnership with external sponsors, as it establishes a framework for the alignment of interests between parties. An important aligning factor is co-investment of equity by the sponsor (typically 2 to 10 percent of the total equity committed), which ensures the sharing in the risk of capital loss. Other structural aspects, such as compensation schemes, are designed to create the incentive to seek appropriate returns while protecting invested capital. Value-added and opportunistic fund arrangements typically establish a management fee calculated on the nominal amount of committed or invested capital and an incentive fee calculated as a portion of the portfolio's profits (typically 15 to 20 percent above a preferred return or "hurdle rate"). By linking the preponderance of compensation to investment returns, this structure incentivizes the manager towards value creation.

Most large funds are managed by capital allocators, sponsors that provide the equity financing for a local operating partner to acquire and manage assets. These large global allocators focus their attention on macro level investment theses and portfolio structuring, utilizing their broad-based investment experience, market knowledge and global network to capitalize on prevailing trends and their impact on cyclical investments. Direct operators take a bottom-up approach, focusing their attention on individual properties where they can increase cash flows and create value through improved operations. These sponsors undertake capital improvements and implement efficient business plans themselves and typically have extensive experience in the local market. Allocators' management control over investments is more removed than that of operators, but they often control major decisions. Moreover, inherent in the allocator fund model is a duplication of the incentive fee structure of a single fund manager. Consequently, investors' returns are negatively impacted by these double promotes (illustrated in Exhibit 2). In return, allocators provide an additional level of expertise, reporting, oversight and fiduciary control.

Another important consideration for investors in commingled funds is the need to reserve capital to meet current and future capital calls without advance knowledge of, or control over, when

EXHIBIT 2: ALLOCATOR *VS.* OPERATOR

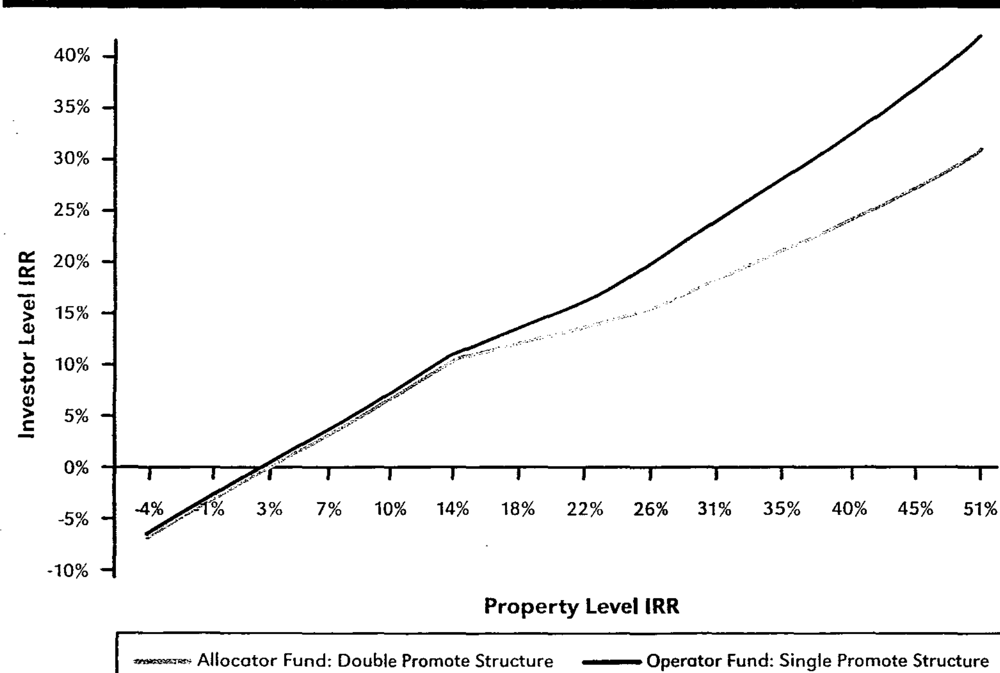
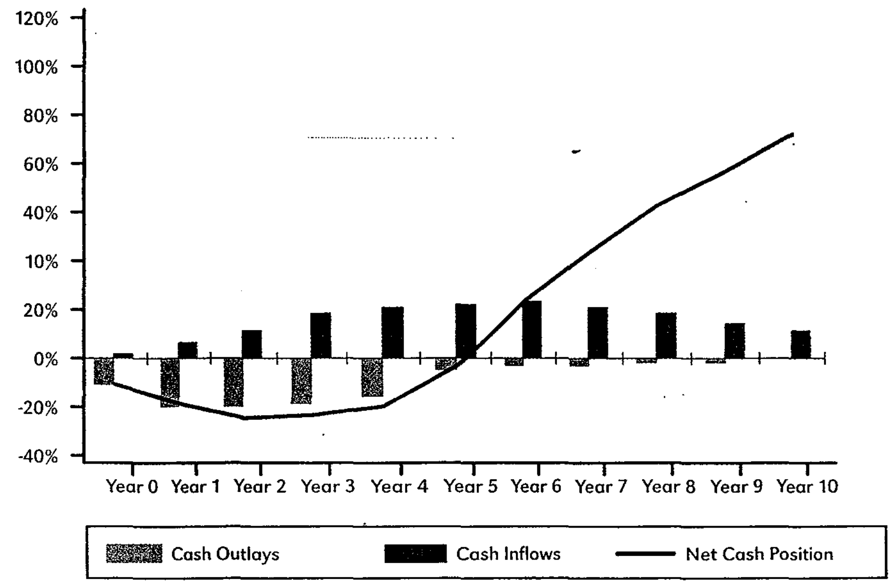


EXHIBIT 3: NET CASH POSITION J CURVE




they may occur. Consequently, investors are obligated to hold shorter-term, liquid securities, thereby incurring a significant opportunity cost. In addition, there is an initial mismatch of cash inflows and outflows, creating a temporarily unfavorable cash stream in the shape of a "J" curve as investors pay management fees on committed equity through the commitment period (typically three to four years) before any investments are made or returns are generated. Exhibit 3 illustrates such a negative net cash position faced by blind-pool fund investors.

Alternative asset classes such as real estate provide powerful mechanisms to reduce risk and enhance returns for well-diversified portfolios. Commingled real estate funds are uniquely suited to benefit investors by providing options otherwise available only to the largest investors. Moreover, current income, generated by many types of real estate, can provide a stabilizing influence and reduce the overall volatility of a portfolio. Commingled funds provide investment managers greater execution efficiency, as real estate opportunities often arise amid rapidly changing market conditions and competition among potential acquirers requires the ability to react quickly. A sponsor with discretionary access to a pool of capital is significantly better positioned to pursue such opportunities, ultimately benefiting the limited partners.

Limited partners must keep a keen eye on a number of issues when investing in commingled funds. Communication and monitoring are important, as limited partners delegate discretion over potential acquisitions and do not have the opportunity to underwrite specific transactions. Additionally, investors should seek to align their interests with those of their general partners through distribution structures and sponsor co-investment. The commingled form of investing has existed since the 1970s and is widely accepted as a sustainable investment model for institutional real estate. However, like any investment structure, it offers both advantages and disadvantages and continues to evolve and adapt to market conditions and investor preferences.

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Frank Schmitz is co-founder and managing principal of Park Hill Real Estate Group, a private real estate equity placement business. Previously, Mr. Schmitz was managing director and head of Real Estate Equity at Principal Real Estate Investors, where he was responsible for portfolio strategy and investment management for private and public market equity clients of Principal Real Estate Investors' $12 billion real estate equity group. Mr. Schmitz is a graduate of Northwestern University and the University of Chicago Graduate School of Business.

**Robert E. Lester, Managing Principal, Park Hill Real Estate Group, LLC**

Rob Lester is a managing principal at Park Hill Real Estate Group, a real estate advisory affiliate of The Blackstone Group, with offices in New York, Chicago, San Francisco, London and Tokyo. Previously, Mr. Lester worked at The Blackstone Group in a variety of roles, including fundraising and as an investment banker with Deutsche Bank Securities and BNP Paribas. Mr. Lester received a BS from the University of California, Riverside, and an MBA from Pepperdine University. Mr. Lester also attended the European Business School in Germany.

**Erin Dobbs, Analyst, Park Hill Real Estate Group, LLC**

Erin Dobbs is an analyst in the Park Hill Real Estate Group and is based in New York. Since joining Park Hill Real Estate, Ms. Dobbs has been a member of Park Hill's real estate origination and project management team. Before joining Park Hill Real Estate, Ms. Dobbs interned for New Trier Partners in Chicago where she worked on acquisitions of industrial portfolios, and Pinnacle Investment Group in Chicago where she structured financing for hotel development. Ms. Dobbs received a BS in communication and business from Northwestern University.

# Chapter 14

## COMMINGLED FUNDS, PART II: STRUCTURE AND LEGAL TERMS

John Wilson and Kathryn Furman, King & Spalding LLP

The purpose of this chapter is to explain the structure and legal terms of a typical US real estate investment fund and to offer a guide to foreign investors as to what they might expect when considering investing in such a fund. Constraint in the US capital market in 2008 and 2009 makes it significantly more difficult for sponsors to raise funds than between the late 1990s through 2007, with the result that fewer funds are currently being formed. The environment has resulted in sponsors making concessions to investors, including offering more favorable fee structures to investors than previously typical. There has been little enough activity during this phase that there is not yet an established set of terms that can be considered typical in this market. The following discussion reflects norms established prior to the current market constraints of the 2008 to 2009 period.

### Discretionary Fund Basics

#### Open-End and Closed-End Funds

Discretionary funds operate as either closed-end funds with a limited term and will liquidate at a pre-determined date, or open-end funds with an indefinite term, admitting and redeeming periodically. Investors are admitted to closed-end funds during a specified period at the beginning of the fund and generally are expected to hold their investments for its entire life. The fund's return to investors is usually expressed as an expected return over the life of the fund and is based on a combination of income from the properties during the life of the fund and anticipated appreciation in the properties that will be realized through liquidation at the end of the term. An open-end fund's expected return to investors is usually expressed as an expected annual return and is largely based on the income generated from the properties held, sales and refinancings of the fund's investments.

#### Structure and Documentation

Most US real estate funds are structured as limited partnerships with the sponsor or an affiliate of the sponsor serving as the general partner and the investors admitted as limited partners. This traditional structure provides limited liability for the investors and subjects the general partner to liability for the fund's liabilities. Some funds are now structured as limited liability companies, offering limited liability protection to all members, including the sponsor or its affiliate. In addition to a partnership or limited liability company that serves as the primary fund entity, a fund's structure may include one or more REITs, feeder vehicles, parallel partnerships or other investment vehicles conceived to address particular concerns of the sponsor or the investors. Fund structures are driven by business and tax considerations, investment strategies, the nature of the investors (tax-exempt investor, ERISA, individuals) and securities regulation concerns.

Investors considering investment in a fund should expect to receive and plan to carefully review a private placement memorandum (PPM). The PPM will summarize the fund's investment strategy and objective, describe the management team's track record and provide a term sheet outlining the key terms of an investment. It also will set forth risk factors and disclose tax, regulatory, securities and other considerations relevant to the fund.

A new investor will complete a subscription agreement pursuant to which it makes its contractual commitment to contribute capital to the fund. In addition to the capital commitment, a typical subscription agreement will contain an investor questionnaire and certain representations and warranties to be made by the investor to determine suitability for the fund and rule out certain tax, ERISA, securities or other regulatory concerns.

The ultimate terms of any fund will be set forth in its governing documents in most instances or limited liability company agreement.

Individual investors in a fund may negotiate side letters with the general partner of the fund to vary the fund's general terms to address concerns particular to the investor. Side letters frequently deal with tax regulatory or reporting issues. In some cases, a side letter will be used to grant special rights or privileges to an investor, such as appointing a representative to the fund's advisory committee or alternative arrangements regarding fees.

Many side letters and some partnership agreements include a "most favored nation" clause stating that if the general partner grants a special right to one investor, any other investor with an equal or larger capital commitment can elect to receive the same treatment. Most favored nation clauses generally exclude rights that address particular tax or regulatory concerns not applicable to other investors.

The business deal between the sponsor and the investors is at the core of any investment structure. Despite diverse structures, most commingled real estate investment funds rely on a similar basic set of terms and allow for generalizations and comparisons among funds. These basic terms are described below. If no distinction exists between open-end and closed-end funds, the discussion applies to both.

## Economic Terms

### Capital Commitments, Capital Calls and Delinquent Limited Partner Provisions

The sponsor's ability to call capital from investors is essential to any discretionary real estate investment fund. The investor's subscription agreement and the partnership agreement establish the terms under which the investor must make capital contributions to the fund. These include the maximum total amount the investor is required to contribute (the investor's capital commitment), the period during which capital may be called by the general partner (the investment period) and the period within which the investor must make a capital contribution (typically seven to 10 days after a capital call). In the case of an open-end fund, unless otherwise specifically agreed with the sponsor, an investor generally is required to contribute the entire amount of its capital commitment when first admitted to the fund. For a closed-end fund, the investment period is typically in the range of two to five years. During the investment period, the general partner has the right to issue capital calls for any purpose permitted under the fund documents. After the end of the investment period, the general partner may make capital calls only to pay fees and expenses of the fund, to make investments committed to before the end of the investment period, and to make additional investments in previously acquired properties. The general partner may not make capital calls for new investments.

An investor's commitment to a fund is structured as a binding contractual obligation and is enforceable as a contract. In addition, the partnership agreement typically will contain an assortment of alternative remedies that the general partner may exercise against a defaulting investor. These remedies typically include some combination of the right to charge interest on delinquent contributions, the right to suspend distributions to a defaulting investor, the loss of the defaulting investor's right to vote, dilution of the defaulting investor's interest in the fund, the right to cover delinquent contributions with a loan from another investor, the right to redeem a defaulting investor's shares at a significant discount, and the right to sell a defaulting investor's shares to a third party at a significant discount. As the economic environment causes more frequent investor defaults, some general partners are working with their advisors to increase the severity of the penalties for default.

**Subscription Lines of Credit**

To provide the fund with working capital and the flexibility to make investments before permanent financing or investors' capital are in place, funds frequently have obtained a subscription line of credit from a bank (a revolving credit line), secured by a collateral assignment of the general partner's right to calls. The lender will loan an amount up to a stated percentage of undrawn capital commitments. In the event of a default, the lender itself may make capital calls on the limited partners (still subject to the limits of their capital commitments) in order to cause repayment of the subscription line. In connection with a subscription line of credit, investors generally will be asked to enter into an "investor letter," confirming their capital commitment to the fund and permitting the lender to exercise the general partner's right to make capital calls. Investors also may be asked for an "investor opinion" issued by their counsel covering due formation, due authority, due execution and other matters as may be requested by the lender. A subscription agreement likely will include a commitment on the part of the investor to enter into investor letters and obtain investor opinions if required by the subscription lender.

**General Partner's Capital Commitment**

In addition to third-party investors, the general partner or an affiliate of the general partner typically also makes a capital commitment to the fund. Whether the general partner is required to make a capital commitment and the amount of such commitment will be set forth in the PPM and may also be included in the limited partnership agreement. When a sponsor is primarily an investment advisor, however, the general partner's capital commitment has in the past often been less than 5 percent of total capital commitments. As investors have begun to focus even more on alignment of interest between the investors and the general partner, they are demanding more substantial commitments by the sponsors, generally 2 to 3 percent with a preference for those in which the sponsor commits at least 5 percent. In cases where the sponsor also invests in real estate in its own right, like a public company that raises a fund to invest in a class of assets, the capital commitments of the general partner and its affiliates may be a significant percentage (often 20 percent or more) of the fund's total capital commitments. The general partner and its affiliates generally should not have the right to vote on matters put to the investors for vote but their capital commitments are otherwise treated the same as those of any other investor's.

**Asset Management Fee**

The capital obtained through capital contributions and subscription line borrowings is used by the fund, under the exclusive control and direction of the general partner, to pay the fund's expenses and to make investments identified and selected by the general partner that are consistent with the fund's investment parameters. In exchange for its services in identifying and evaluating prospective investments, monitoring investments, and determining dispositions and exit strategies, the fund or the investors pay the general partner an annual management fee. Most closed-end funds in the past have expressed the management fee as a percentage of committed capital during the investment period and a percentage of invested capital after the investment period. Given the difficulty of raising capital in 2008 and 2009, some general partners now offer a management fee based on a percentage of invested capital throughout the term of the fund. In the case of open-end funds and some closed-end funds, the management fee is a percentage of net asset value or net operating income. The level of such fees typically ranges from 1 to 2 percent of committed or invested capital per year. In some cases, a fund will offer tiered fees, such that investors with larger capital commitments pay a lower percentage than those with smaller capital commitments.

**Distributions and the General Partner Promote**

All cash distributed by the fund is distributed to the investors according to a formula, often referred to as the "distribution waterfall" set forth in the partnership agreement and disclosed in the PPM. Some funds include separate distribution waterfalls for cash generated by the ongoing operation of properties and cash generated by a capital event, such as the disposition of a property.

In addition to distributions based on its capital commitment and related contributions, the distribution waterfall provides the general partner with a share (typically 15 to 20 percent) of the profits attributable to the investors' capital contributions. The general partner's share is often referred to as the "carried interest" or the "promote," and is paid separately from any management or other fees paid to the general partner or its affiliates.

Before distributing profits in a closed-end fund, the waterfall will return all or a portion of their capital to the investors. The terms of the fund will determine whether this means return of all invested capital or only the portion that went into previously sold or written-off investments. In the current constrained market, the tendency is for funds to return all invested capital before distributing profits rather than making distributions on individual deals. Once capital has been returned (or in some cases before), the investors are usually entitled to receive a specified return on their capital contributions, called a preferred return, before the general partner receives distributions of its promote.

In some cases where investors receive a preferred return, the general partner is subsequently entitled to a disproportionately large share of incremental profits until the general partner has received its promote percentage on total profits. This arrangement is often referred to as a "catch-up" and results in the general partner receiving its promote percentage on all profits, not just those above the preferred return, as would be more typical in a joint-venture arrangement.

A distribution waterfall with a full return of capital, an 8 percent preferred return, a 60/40 catch-up, and a 20 percent promote might read as follows.

*Each distribution will be tentatively allocated among the partners (including the general partner) in proportion to their respective aggregate capital* *contributions. Then, each limited partner's tentative share of such distribution shall be divided further between such limited partner, on the one hand, and the general partner, on the other hand, as follows:*

***Clause (a)** First, to the limited partner, until the limited partner has received cumulative distributions pursuant to this clause equal to the aggregate capital contributions made by such limited partner;*

***Clause (b)** Second, to the limited partner, until the limited partner has received cumulative distributions pursuant to this clause sufficient to provide an 8 percent cumulative, compounding annual return on the aggregate unreturned capital contributions made by such limited partner, calculated based on the actual date that each such capital contribution was made;*

***Clause (c)** Third, 60 percent to the general partner and 40 percent to the limited partner, until the general partner has received cumulative distributions pursuant to this clause equal to 20 percent of the sum of (i) cumulative distributions made to date to the limited partner pursuant to Clause (b) and this clause and (ii) cumulative distributions made to the general partner pursuant to this clause; and*

***Clause (d)** Thereafter, 20 percent to the general partner and 80 percent to the limited partner.*

To apply the waterfall set forth above, if the partnership had two limited partners and $200 to distribute, the general partner had made capital contributions in the aggregate amount of $20, Limited Partner A had made capital contributions in the aggregate amount of $30, Limited Partner B had made capital contributions in the aggregate amount of $50, and all capital contributions had been outstanding for a period of one year, distributions would be made as follows.

Pursuant to the introductory paragraph of the distribution waterfall, the $200 available for distribution would be tentatively allocated among the partners (including the general partner) in proportion to their respective aggregate capital contributions: $40 for the general partner, $60 for Limited Partner A and $100 for Limited Partner B. Then, the amount allocated to the general partner would be distributed to the general partner and the amount allocated to each limited partner would be further allocated between such limited partner and the general partner and distributed as follows:

With respect to Limited Partner A:
(a) First, $30 would be allocated to Limited Partner A to return its aggregate capital contributions;

(b) Second, $2.40 would be allocated to Limited Partner A to provide an 8 percent cumulative, compounding annual return on its aggregate capital contributions;

(c) Third, $0.72 would be allocated to the general partner and $0.48 to Limited Partner A, so that the general partner has received distributions equal to 20 percent of $3.60 ($3.60 being the sum of $2.88 in cumulative distributions to Limited Partner A (distributed pursuant to Clauses (b) and (c)) and $0.72 in cumulative distributions to the general partner (distributed pursuant to Clause (c)); and

(d) Thereafter, out of the remaining $26.40 of the $60 of available distributions initially allocated to Limited Partner A (pursuant to the first paragraph of the distribution waterfall), 20 percent, or $5.28, would be allocated to the general partner and 80 percent, or $21.12, to Limited Partner A.

Then, with respect to Limited Partner B:
(a) First, $50 would be allocated to Limited Partner B to return its aggregate capital contributions;

(b) Second, $4 would be allocated to Limited Partner B to provide an 8 percent cumulative, compounding annual return on its aggregate capital contributions;

(c) Third, $1.20 would be allocated to the general partner and $0.80 to Limited Partner B, so that the general partner has received distributions equal to 20 percent of $6.00 ($6.00 being the sum of $4.80 in cumulative distributions to Limited Partner B distributed pursuant to Clauses (b) and (c) and $1.20 in cumulative distributions made to the general partner (distributed pursuant to Clause (c)); and

(d) Thereafter, of the remaining $44 of the $100 of available distributions initially allocated to Limited Partner B (pursuant to the first paragraph of the distribution waterfall), 20 percent, or $8.80, would be allocated to the general partner and 80 percent, or $35.20, to Limited Partner B.

The ultimate distributions thus would be $54 to Limited Partner A, $90 to Limited Partner B and $56 to the general partner. The general partner's distribution would be the sum of the $40 distributed with respect to its own investment, the $6 in promote distributed with respect to Limited Partner A's investment and the $10 in promote distributed with respect to Limited Partner B's investment. Because this example includes the catch-up mechanism set forth in Clause (c) and we assumed that the total amount distributed would be sufficient to satisfy each tier of the waterfall (meaning that distributions would in fact be made pursuant to Clause (d)), even though each limited partner receives a preferred return before the general partner is paid a promote, the general partner's promote with respect to each limited partner would equal a full 20 percent of the profits distributed to such limited partner (20 percent of the $80 of aggregate profit distributed to limited partners is $16).

If the distribution waterfall did not include a catch-up mechanism, the general partner's promote with respect to each limited partner would be equal to 20 percent of the profits distributed to such limited partner after the 8 percent preferred return had been paid to the limited partner. In the example set forth above, without the catch-up specified in Clause (c) of the distribution waterfall the ultimate distributions would be $54.48 to Limited Partner A, $90.80 to Limited Partner B, and $54.72 to the general partner. In this case, the general partner's distribution would include $40 distributed with respect to the general partner's own investment, $5.52 in promote distributed with respect to Limited Partner A's investment and $9.20 in promote distributed with respect to Limited Partner B's investment.

Since an open-end fund is not expected to liquidate within a specific time period, regular (often quarterly) distributions of cash flow are made *pro-rata* to the investors, after distribution of the general partner's promote. Rather than receiving a liquidating distribution upon liquidation of the fund, an investor may, subject to certain limitations, request that the fund redeem its shares whenever the investor is ready to exit the investment. An exiting investor's shares are redeemed at the same price an incoming investor would pay to purchase shares in the fund at that time. The sale or redemption price of a share is based on the fund's net asset value, which in accordance with the fund's valuation policy is calculated by the general partner at regular intervals.

The general partner's promote in an open-end fund is calculated at regular intervals, and any increase that would result in a hypothetical liquidation of the fund is distributed to the general partner. In order to determine the promote that would be payable to the general partner if the fund were to liquidate, the net asset value is run through a waterfall similar to that in a closed-end fund. Any resulting increases are distributed to the general partner prior to the *pro-rata* distribution of cash flow to the investors described above.

### Other Fees to Affiliates

In addition to the asset-management fee, a fund may pay a variety of fees to the general partner or its affiliate for services provided to the fund. Depending on the type of property, the sponsor's area of expertise and the nature of the fund, these may include a property management, leasing, development, construction management, acquisition or disposition fees. The partnership agreement should require that such services be provided at rates and on terms and conditions comparable to those that would be negotiated with a third party at arms-length. Any such fees should be disclosed in the PPM and may be set forth in the partnership agreement. Transactions between the fund and the general partner or any affiliate of the general partner other than those explicitly disclosed in the PPM or partnership agreement generally will require disclosure to, or the approval of, the advisory committee, or some other subset of the investors.

### Reinvestment Provisions

Some closed-end funds permit the reinvestment of capital or of capital and profits, by the general partner during the investment period. Funds that permit the general partner to withhold capital from distributions for reinvestment often also permit it to recall for reinvestment capital previously distributed during the investment period. These reinvestments are subject to the same investment limitations and controls as are initial investments.

### General Partner Clawback

If early sales by a closed-end fund generate profits and later sales do not, and the promote is paid on individual investments, it is possible that the general partner could receive promote distributions that exceed the promote distributions that would be payable during the entire life of the fund. Even with a closed-end fund that pays promote only after the return of all capital, there are some scenarios where the general partner could receive excess promote, such as if it returned all capital and received promote distributions, but subsequently reinvested capital only to lose all or some portion of it. In some funds, such situations are addressed through an obligation on the general partner to return to the fund all or part of the promote distributions previously received so that cumulative promote distributions to the general partner do not exceed the promote percentage. Such an obligation is referred to as a "general partner clawback" or "general partner giveback." A general partner clawback obligation is generally net of taxes paid by the general partner on the original distributions. Where the general partner is a single-purpose entity, its clawback obligations may be guaranteed by the sponsor or the general partner's parent entity.

### Limited Partner Clawback

Some partnership agreements permit a closed-end fund to recall distributed monies from investors in order to reimburse a legal judgment imposed on the fund or the general partner. This right to recall money distributed to investors is referred to as a "limited-partner clawback" and often survives the termination of the fund for a period of two to three years. The investors' liability should be limited to a percentage of distributions or capital commitments or to distributions made over a specific period of time. A limited-partner clawback provision is more typical of private equity funds, but in some cases appears in real estate funds.

## Governance Terms

### Investment Limitations

The general partner of a commingled fund has significant discretion to make decisions on behalf of the fund. The general partner's investment decisions are made within the parameters of the investment strategy described in the PPM and certain guidelines and limitations set forth in the partnership agreement. Investment limitations generally take one of two forms: strategic definition or fund diversification. Limitation by strategic definition relates to the investment strategy and defines the sort of property in which the fund intends to invest. The limitations may restrict the type of asset (retail, industrial, office, multifamily, hotel, *etc.*); development status (whether the property is under development, stabilized, or in need of renovation or redevelopment); location (such definitions may specify country, region, or markets or types of markets); or the size of the property to be acquired (either in terms of price or square footage). Fund diversification limitations are intended to allow investment decisions that promote diversification of the fund's portfolio. Such limitations often relate to geographic concentration of assets or the size of individual assets relative to the intended size of the portfolio. As long as the general partner's investment decisions comply with these limitations, the general partner typically need not seek the approval of any limited partner for its investment decisions.

**Leverage Policy**

Most funds include a policy regulating the use of leverage by the fund. Some leverage policies take the form of a simple threshold, usually measured at the time debt is incurred. Organizing documents may specify, for example, that "the fund may not incur indebtedness if, at the time of incurrence, doing so would cause the aggregate indebtedness of the fund to exceed 65 percent of the aggregate gross value of the fund's assets." Other leverage policies go into significantly more detail about what kind of debt may be incurred. Such a detailed policy might address the amount of debt permitted with respect to a single asset or investment, whether and how much floating- or adjustable-rate debt is permissible, whether and to what extent debt may be cross-collateralized, whether or not debt may grant recourse to a particular entity, and whether and on what basis the debt must permit substitution of collateral. It may be that conditions in the market for real estate debt in 2008 and 2009 are doing more to constrain fund sponsors' use of leverage than even draconian fund leverage policies, causing investors to be less focused on the issue, but we trust that this will change with time.

**Exclusivity**

Some general partners or sponsors offer a fund the exclusive right to acquire a particular type of property during a specified period of time. The type of property subject to the exclusivity arrangement usually, but not always, coincides with the fund's investment guidelines and restrictions. Exclusivity usually includes several exceptions, intended either to preserve the sponsor's right to engage in transactions that could not be accomplished by investing through the fund or to prevent the fund from acquiring properties inappropriate for its goals and objectives. Typical exceptions include properties acquired in tax-deferred transactions (such as 1031 transactions or exchanges for "down-REIT" units in the sponsor); properties adjacent to or in close proximity to others owned by the sponsor; properties not targeted by the fund due to geography, purchase price, size or other characteristics usually specified in some detail in the exception; or properties that the general partner has in good faith determined are not appropriate for the fund.

In cases where a sponsor wishes to offer exclusive rights to more than one fund or other investment vehicle, it may rely on an allocation policy to determine which investment vehicle should be offered a specific property. Allocation policies usually select which of the investment vehicles should be offered the right to acquire a particular property based on a set rotation known to each of the investment vehicles or an allocation committee decides which should have the opportunity. A sponsor following an allocation policy may report annually how investments have been allocated.

### Advisory Committee

Many funds include an advisory committee to allow the investors to have some influence on the fund's policies. An advisory committee also allows the general partner to interact with and obtain consent from a small group of investor representatives on a regular basis. The advisory committee is typically made up of representatives of the investors selected by the general partner. Investors with a relatively large investment in the fund may be able to secure a side-letter commitment from the general partner that they will be represented on the advisory committee.

The partnership agreement will specify the matters subject to the approval of the advisory committee, including the margin by which such matters must be approved (unanimous, majority-in-interest or some other percentage) and how votes are allocated (per-head or in proportion to percentage interests). There is significant variation among funds on the issue of which matters will be submitted to the advisory committee. Some require advisory committee approval only for conflicts of interest and deviations from specified policies, while others permit the advisory committee to approve annual operating budgets, variations from investment or other policies and more.

### Transfers of Interest and Redemptions

In both closed- and open-end funds, an investor should expect to have limited rights to transfer its interest. Any transfer of interest will typically require the general partner's written consent, which the partnership agreement may allow to be given or withheld in the general partner's sole discretion or may specify cannot be unreasonably withheld. Transfers to affiliates may be explicitly permitted under some partnership agreements, or may be permitted by negotiated side letters. In some cases, the fund may have a right of first refusal over transfers. In a case where a transfer is not explicitly permitted, the transferor and transferee may be required to pay any costs accruing to the general partner and the fund in connection with the transfer, and to provide legal opinions.

Investors in an open-end fund usually have a right to apply for redemption of their interests, although they may be required to hold their interests for some specified period of time before they can request redemption. When an investor requests redemption, if the fund has sufficient cash available, it will repurchase the limited partner's interest at a price specified in the partnership agreement. The redemption price is typically based on the fund's net asset value, is generally defined as the value of all assets held by the fund less the amount of its indebtedness, with the value of properties being determined by third-party appraisals conducted on some routine basis. Investors can expect that the definition of net asset value set forth in a partnership agreement will be very detailed, specifying by what means and how often assets will be valued, how debt is accounted for, and how the calculation of net asset value will be made. The partnership agreement will also specify how to determine whether the fund has sufficient cash available to redeem an investor's interest and if, when, and on what terms the fund must take actions such as selling or refinancing properties in order to make cash available to redeem investors' interests. If multiple investors have requested redemption, or if the fund has insufficient cash to make a redemption, those requesting redemption will enter a "redemption queue" to be redeemed when the fund has sufficient cash. Investors in the redemption queue are generally redeemed *pro-rata* to the extent of the cash available for redemptions.

### Key Person Provisions

Because the general partner has broad discretion with respect to a commingled fund, in cases where the general partner or sponsor's expertise is based on the expertise of a particular individual or group of individuals, the partnership agreement may include a "key person" provision that specifies certain consequences if the key person ceases to devote a specified amount of his or her time to the fund or to maintain its level of responsibility with respect to the fund. In the case of a group of individuals, the key person provision may be triggered if a specified number of the key persons, or one specified key person and a specified number of other individuals, ceases to meet the requirements for commitment of time and responsibility. In cases where there is a group of key persons, the partnership agreement will often include a mechanism for replacement of a key person by a similarly qualified individual without triggering remedies. The most common remedy for violation of key person requirements is a suspension of the investment period until such time as the key person requirements are met. In some cases, violation of the provision may trigger a termination of the investment period. If the key person requirements cannot be met within a specified period of time (usually between four months and a year), investors representing a majority interest may have the right to remove and replace the general partner or to require the fund to liquidate.

### Removal of the General Partner

Because commingled funds permit the general partner to exercise significant discretion, the ultimate control afforded to the investors lies in removal of the general partner. Nearly all funds permit removal of the general partner "for cause." The typical definition of "cause" will include acts of fraud, bad faith and gross negligence, and possibly other acts such as the breach of a designated standard of care. In addition, some funds permit the investors to remove the general partner without cause, which is to say for any reason or no reason at all.

Removal of the general partner is generally accomplished by a vote of the investors, excluding the general partner and any of its affiliates. A simple majority-in-interest vote may suffice to remove a general partner, or a significantly higher threshold may be required. A fund may require a greater percentage to vote in favor of removal "not for cause" than may be required in a "for cause" removal.

Upon removal of the general partner, the partnership agreement may permit the investors to bring in a substitute general partner, or may require that the fund liquidate. It may also allow for different remedies in "for cause" and "not for cause" removals.

### Liability and Indemnity

Except for certain "disabling conduct" such as fraud or negligence, the general partner generally is exculpated and will receive indemnity for all losses. The definition of "disabling conduct" varies in partnership agreements. In some it is limited to fraud, bad faith or gross negligence. Others impose a standard of care obligation, such as the obligation to act with the same care and skill as a reasonably prudent real estate investment manager.

While the terms of commingled real estate investment funds will vary based on the sponsor's investment strategy, objectives and negotiations with investors, most funds rely on similar basic terms. When considering investment in any particular fund, investors should review the PPM and partnership agreement in detail. A review of several term sheets for several commingled real estate investment funds will reveal a range of idiosyncratic terms, but also general adherence to the basic structure and concepts described above.

**John Wilson, Partner, King & Spalding LLP**

John Wilson is a partner in King & Spalding's Corporate Group and is actively involved in the firm's Real Estate Capital Markets Group, which includes funds formation and offerings, public and private merger and acquisition transactions, "going private" transactions, stock and asset sales and partnership and other joint venture transactions. Mr. Wilson also has experience in a broad range of corporate finance transactions and securities matters and advises corporate clients regarding SEC reporting and disclosure requirements, securities transactions and other corporate governance and compliance matters.

**Kathryn Furman, Partner, King & Spalding LLP**

Kathryn Furman is a partner in King & Spalding's Corporate Group. Ms. Furman advises fund sponsors in the structuring and formation of investment funds and fund investors in reviewing and negotiating the terms of their investments. She routinely counsels such clients on exemptions and other compliance matters under the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

# Chapter 15

## ISLAMIC FINANCE: BASIC PRINCIPLES AND STRUCTURES

Andrew Metcalf, King & Spalding LLP

### PRINCIPLES IN ISLAMIC FINANCE

Islamic, or *Shari'ah*-compliant, finance refers to finance and investment practices employed by individuals and institutions who wish to invest in compliance with *Shari'ah*, or Islamic law. These practices emanate from a central core comprising the *Quran*, the holy book of Islam; the *Sunna*, practices instituted or approved by the Islamic Prophet Mohammed during his lifetime; the *Hadith*, oral traditions relating to the words and deeds of the Prophet Mohammed; the *ijma*, or consensus, of the Muslim scholars; and the *qiyas*, reasoned determinations based on analogy to established principles.

Probably the best-known feature of Islamic finance is the prohibition of interest. This prohibition, not universally shared by Muslims but a central tenet of Islamic finance, derives from the prohibition of *riba* (translated literally, excess). *Shari'ah* scholars continue to debate *riba*'s exact nature, but generally speaking *riba* can be described as unearned excess obtained by one party in a transaction, or as profit earned without countervailing value. In the case of interest, the concept is further complicated by the *Shari'ah*'s classification of money as solely a medium of exchange, as opposed to an asset with intrinsic value. This classification suggests that money cannot be leased or loaned to someone in same manner as a true asset, and, therefore, that interest — which is tantamount to rent charged for the use of money — is forbidden.

Islamic finance also prohibits impermissible speculation (*maisir*) and uncertainty (*gharar*). These concepts, which overlap to a degree, do not prevent parties from undertaking risks normally associated with business ventures. *Maisir* refers to transactions that depend upon pure chance, instead of effort, to generate a return. The meaning of *gharar* presents a greater conceptual challenge because it lacks an established definition, and it encompasses a number of ideas such as impossibility of delivery, fraud and uncertainty regarding the object of contract. Fraud aside, however, *gharar* arises when the subject matter of a transaction is so uncertain in terms of identity or assuredness of performance that the transaction amounts to gambling. Some *Shari'ah* scholars assert that *maisir* and *gharar* prohibit life insurance contracts and derivative contracts such as swaps.

Finally, Islamic investors are prohibited from investing in companies (or, in the case of real estate investments, from leasing to companies) that are engaged in activities considered harmful or un-Islamic (*haram*), such as gambling or the production of alcohol, pork products, weapons and pornography. These restrictions effectively prevent Islamic investors from investing in casinos and, in some cases, hotel properties.

If one had to identify a single theme running through these prohibitions it would be the encouragement of fair and productive economic activity. Equity investments are favored in Islamic finance because equity participants are bound by a shared interest in their venture's success or failure. Asset-based transactions are favored because they are thought to provide safeguards against purely monetary, spurious activity. Because of this, many Islamic investors consider real estate an ideal investment.

Islamic finance practices are not uniform throughout the Muslim world. Numerous factors contribute to this variety, including divergence in the concepts adhered to by the four main schools of Sunni Islam, geographic differences and continuing innovation. In practice, the rules followed by any particular Islamic financial institution or *Shari'ah*-compliant fund are determined by one or more *Shari'ah* advisors, who must approve the venture's investments, ownership and financing structures. *Shari'ah* advisors may not all assume the same position on key issues, so structures or contractual arrangements approved by one may not be acceptable to another. The differences tend to be most pronounced between advisors based in countries that are members of the Gulf Cooperation Council and those based in Southeast Asia. Efforts have been made to encourage more uniformity among *Shari'ah* advisors, in the hopes of creating a broader-based market. For example, the Accounting and Auditing Organization for Islamic Financial Institutions, a non-profit organization formed in 1990 and supported by central banks, Islamic financial institutions and other market participants, issues *Shari'ah* standards developed in consultation with industry practitioners. Though these standards have been adopted in many jurisdictions, adoption is not obligatory. Other influential standard-setting bodies include the *Fiqh* Academy of the Organization of the Islamic Conference, the *Shari'ah* Supervisory Board of the Islamic Development Bank, and the Islamic Financial Services Board based in Kuala Lumpur. By providing forums for the discussion of standards, these organizations have also fostered the development of new Islamic finance structures and ideas.

### Structures in Islamic Finance

The central concepts that underlie Islamic finance have existed for over a thousand years, but only recently has modern Islamic finance practice emerged in earnest. Most commentators trace the origin of its significant development back to the 1990s. Although Islamic finance still represents a fairly modest percentage of global economic activity, it has grown rapidly in volume, importance and sophistication since that time. Growth and development trends suggest that Islamic finance transactions may change significantly in the intermediate to long term. Indeed, a number of commentators and scholars predict and or advocate for fundamental alterations in current Islamic finance practice. Accordingly, variety and change will likely be hallmarks of Islamic finance for the foreseeable future. Nonetheless, there are some basic financing structures currently employed for US real estate investments that will remain common, at least in the short to intermediate term. These investment structures are designed to comply with *Shari'ah* and with US legal, tax and corporate requirements. Transactional structures will necessarily vary according with the details of each particular investment, but the descriptions to follow outline the basic parameters of these structures.

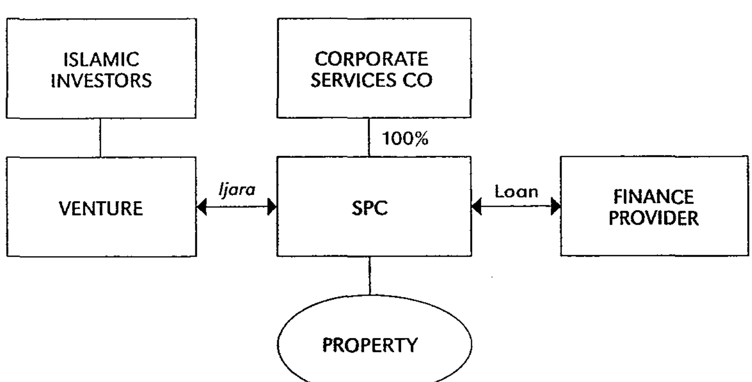
***Ijara* (Lease) Structure**

*Ijara* is by far the most commonly used Islamic finance structure in the US for real estate acquisition financing. It can also be used for corporate acquisitions and asset-purchase financing. An *ijara* transaction may be analogized to a conventional financing lease, with some structural differences. In an *ijara* transaction, a finance provider leases to an Islamic fund, company or investor (the "Venture") an asset that the finance provider has previously acquired or caused to be manufactured. The Venture usually has an option to purchase the leased property at the end of the *ijara* term for a pre-established price.

In theory, a bank or other financial institution acting as finance provider under an *ijara* could own the leased property and lease it to the Venture directly. However, because US laws restrict the ability of banks to own and lease real estate, most US *ijara* structures employ a special purpose company (SPC) to hold real estate assets. The SPC is interposed between the finance provider and the Venture, and is typically owned and operated by an independent third party with no financial interest in the *ijara* or the leased property. In real estate transactions, the SPC will usually finance its acquisition of the leased property by obtaining a conventional mortgage loan from the finance provider. This arrangement affords the finance provider a degree of certainty, allowing it to use familiar loan and security documentation. Following acquisition, the SPC will lease the property to the Venture under an *ijara*. The *ijara* documentation will contain most of the representations, covenants and specify the events of default that a finance provider would expect to have in conventional mortgage documentation. The *ijara* will also provide for periodic rent payments to the SPC. The *ijara*'s rent provisions will be drafted to ensure that the SPC has sufficient amounts to make all payments due under its conventional mortgage loan with the finance provider. Exhibit 1 depicts a typical *ijara* arrangement.

An *ijara* must satisfy a number of potentially conflicting *Shari'ah* and US tax requirements, a tension that presents one of the key challenges in structuring these investments. Notwithstanding that the SPC holds title to the leased property, the Venture will typically seek to be treated as the owner of the property for US tax purposes so that it can enjoy tax benefits such as depreciation. To achieve that tax treatment, the *ijara* and related documentation must allocate to the Venture both the benefits and burdens of the real property's ownership. However, *Shari'ah* requires that an *ijara* must assign to the SPC

EXHIBIT 1: *IJARA* STRUCTURE



certain responsibilities associated with ownership of the leased property. Among other things, this requirement seeks to ensure the fair and proper allocation of responsibilities between landlord and tenant. For example, an *ijara* should provide that the owner of leased property is responsible for major maintenance and structural repairs for such property. In addition, responsibility for property damage insurance should be allocated to the SPC, as landlord, rather than the Venture, as tenant. This tension between tax and *Shari'ah* requirements must be addressed carefully.

Finally, just as the *ijara* between the SPC and the Venture must conform with *Shari'ah*, so too must any tenant leases that will be assumed or executed by the Venture in its capacity as sublessor. Although apartment tenant leases often allocate responsibilities between landlord and tenant in a *Shari'ah*-compliant manner, commercial leases generally contain triple-net provisions that divide these responsibilities differently. Investment funds have adopted varying approaches to resolve this issue including, where possible, lease modification.

### *Istisna'a* Structure

Although the *ijara* is the most common structure for *Shari'ah*-compliant real estate investment, other arrangements (as well as variations of the *ijara* structure) are also employed. One such structure, the *istisna'a*, is used primarily to finance real estate development projects. An *istisna'a* contract is a sale contract for an item that has not yet been produced that can be used to finance the item's production. Under a typical *istisna'a* structure involving real estate in the US, the Venture hires an SPC to construct real property improvements in accordance with specifications provided by the Venture, and agrees to purchase or lease those improvements from the SPC upon completion. The SPC arranges for financing to support work undertaken during the construction phase and contracts with a contractor and or construction manager. Upon completion of construction, the SPC sells the improvements to the Venture, or leases them to the Venture under an *ijara*. The terms of the sale or lease arrangements will vary depending upon the requirements of the project. The SPC uses amounts received from the sale or lease of the developed property to pay its financing obligations incurred during the construction phase. Exhibit 2 depicts a typical *istisna'a* arrangement.

### *Murabaha* Structure

A *murabaha* transaction is essentially a cost-plus financing. It involves the purchase of a property by an SPC or Islamic financial institution and the immediate resale of the property to a Venture at cost plus an agreed profit. Like many other Islamic finance structures, a *murabaha* can be used to finance the acquisition of a variety of assets other than real property. Usually the purchase price is

**EXHIBIT 2: *ISTISNA'A* STRUCTURE**

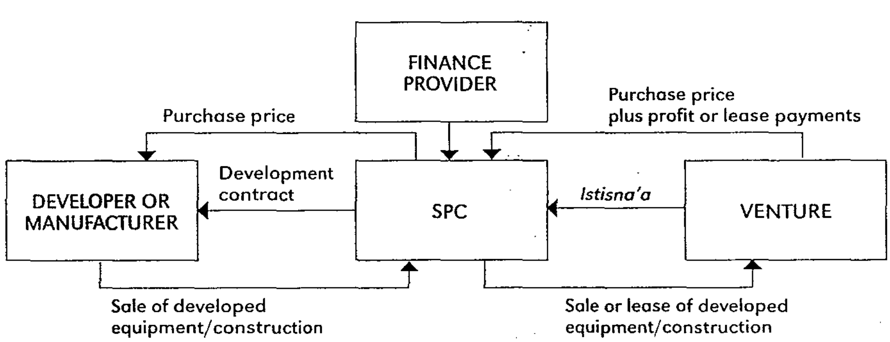
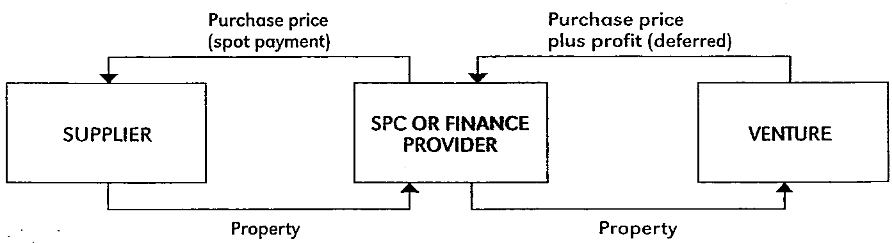


**EXHIBIT 3: *MURABAHA* STRUCTURE**




paid by the Venture in installments over an agreed period of time, and in a real estate transaction the obligations of the Venture would usually be secured by a mortgage. Although the *murabaha* structure has the advantage of placing title to the property in the hands of the Venture, prepayment restrictions, transfer tax and pricing constraints have limited the use of the *murabaha* for real estate investments in the US. However, this structure has been favored in other jurisdictions where the *ijara* structure presents certain legal problems. Exhibit 3 depicts a typical *murabaha* arrangement.

### *Mudaraba* Structure

A *mudaraba* is a quasi-partnership arrangement, in which an investor party (the *rab al mal*) provides capital while a second party (the *mudarib*) provides expertise. *Mudaraba* is commonly used to establish investment funds that make *Shari'ah*-compliant investments. The *mudarib* typically exercises wide discretion in making investment decisions and earns a fee, usually based on a share of the profits. The *mudaraba* parties share profits according to established percentages, which can be highly structured and negotiated. However, only the *rab al mal* bears the risk of losing its economic investment; the *mudarib*'s losses will be limited to its time, effort and anticipated income. *Mudaraba* can be combined with other structures to make specific investments. For example, a *mudaraba* partnership can enter into an *istisna'a-ijara* arrangement with a third party finance provider to finance the construction and operation of an investment property. Exhibit 4 depicts a typical *mudaraba* arrangement.

**EXHIBIT 4: *MUDARABA* STRUCTURE**

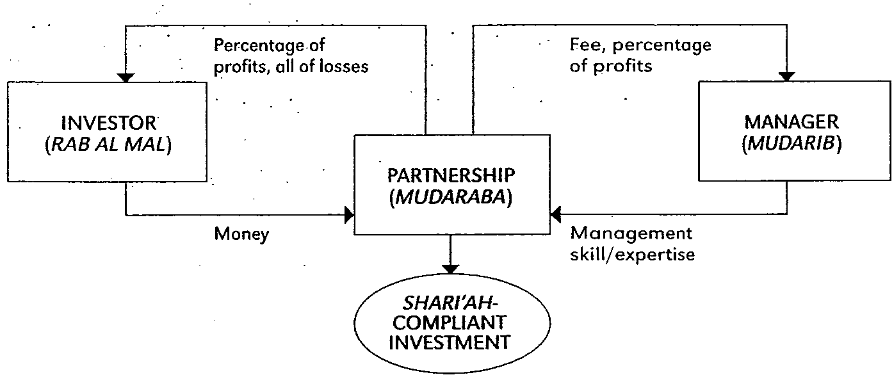
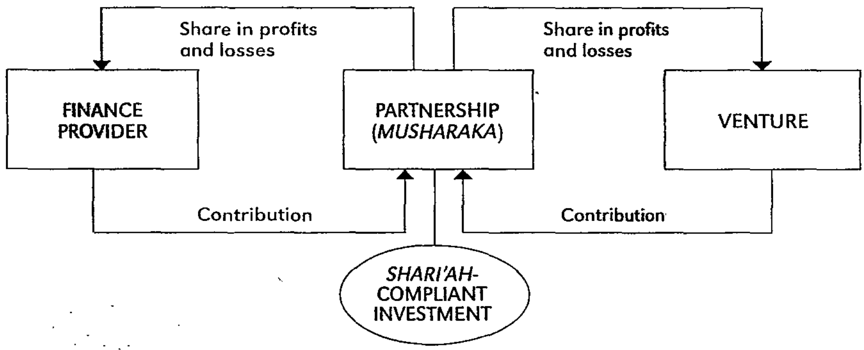


EXHIBIT 5: *MUSHARAKA* STRUCTURE




### *Musharaka* Structure

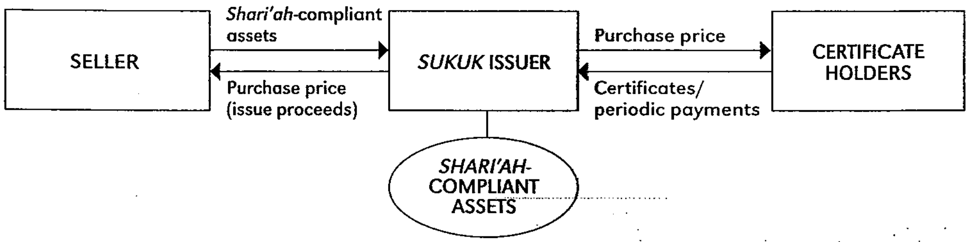
The *musharaka* is a partnership arrangement and is regarded by many as the purest form of Islamic finance because it features profit and loss sharing. Under a *musharaka*, all partners contribute capital in the form of cash and or property. The parties share profits according to an agreed ratio (as with the *mudaraba*), but the parties also share losses in proportion to their capital investments. All *musharaka* parties have the right, but not the obligation, to exercise control of the *musharaka*, although in practice such control is usually exercised by a managing partner.

A variation of the *musharaka*, the so-called diminishing *musharaka*, is sometimes used for residential mortgages. Under this arrangement, a finance provider enters into a *musharaka* arrangement with its customer under which the finance provider contributes cash and the customer contributes property and cash. The finance provider receives payment of a periodic return during the term of the agreement, but its share in the *musharaka* also diminishes over time as the customer gradually purchases 100 percent of the *musharaka* interests (and thus, the home that is the property of the *musharaka*). Exhibit 5 depicts a typical *musharaka* arrangement.

### *Sukuk*

*Sukuk* are certificates or similar instruments that represent an undivided ownership share in underlying *Shari'ah*-compliant assets held by the certificate issuer. They are often referred to as Islamic bonds, but differ structurally from bonds in some basic respects. Most importantly, while conventional bonds represent debt obligations of the bond issuer itself, *sukuk* represent shares in the assets held by the *sukuk* issuer, including the income generated by such assets. In principle, the *sukuk* issuer simply passes on the amounts generated by the *sukuk* assets to the *sukuk* holders. Nevertheless, *sukuk* are often analogized to bonds because their payment characteristics often do resemble bond returns. For example, if the *sukuk* issuer owns and leases assets under an *ijara* in return for payment of a fixed-rate rent, then the holder of *sukuk* certificates in these assets and their related *ijara* would receive a bond-like fixed return. Some *sukuk* issuances are supported by a guaranty issued by an entity associated with or otherwise sponsoring the issuer. Since these guaranties represent the direct obligations of the guarantor, they somewhat blur the distinction between *sukuk* and conventional bonds. Recent criticism of the structuring of certain *sukuk* issuances and the decrease of securitization activity generally have hampered what had been rapid growth in *sukuk* issuances worldwide. In the long term, however, this is likely to be a significant

**EXHIBIT 6: *SUKUK* STRUCTURE**




technique for arranging investments in asset pools. Exhibit 6 depicts a typical *sukuk* arrangement.

### General Structuring Considerations

All of the structures described in this chapter are based on so-called nominate contracts, which are modern incarnations of contracts dating back several centuries identified in the writings of Islamic legal scholars. As noted previously, nominate contracts may be combined in structuring transactions, with each contract addressing a distinct capital requirement. Some modern commentators have suggested that using nominate contracts is overly formalistic and should be abandoned in favor of newly developed techniques based on core Islamic financial principles. Such new techniques would probably take years to develop and popularize. As a result, at least for the short to intermediate term, the structures described here will likely dominate Islamic financial practice.

The structures discussed above represent only basic outlines for transactions that are often extremely complicated. Participants must also address a host of US legal issues not covered in this chapter, including tax treatment, bankruptcy and proper recordation of ownership rights. Many of these issues arise because of particular *Shari'ah* requirements. With careful and creative thinking, however, solutions that reconcile the sometimes contrary requirements of *Shari'ah* and US law can be found.

**Andrew Metcalf, Partner, King & Spalding LLP**

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# Chapter 16

## RULES APPLYING TO REAL ESTATE INVESTMENT AND OPERATIONS: THE BASICS OF US REAL ESTATE LAW

Tim Tucker, King & Spalding LLP

For many international investors, forays into US real estate markets reveal a new and unfamiliar set of ownership rules and government regulations. An adequate understanding of these is necessary to implement a successful investment strategy. While a prudent investor will engage attorneys, accountants, engineers, architects and other real estate experts to render advice, the investor also must have a basic understanding of the ownership rules and legal systems applicable to US real estate in order to assemble the correct team of experts and to assimilate and understand the experts' advice.

### Rules Governing Ownership of US Real Estate — Types of Ownership Interests

The most common forms of interest in US real estate are fee-simple absolute, leasehold estates, easements and licenses. These interests, with limited exceptions, are obtained by grants or conveyances contained in legal documents.

#### Fee-Simple Absolute Ownership

A fee-simple absolute interest in real estate is the most comprehensive form of ownership and is conveyed by deed. In its purest form, fee-simple absolute ownership is perpetual and includes all rights and interests in the owned real estate, including ownership of the land, all buildings and other structures attached to the land, and all rights to minerals, timber and other products of the land. However, fee-simple ownership most often is acquired subject to certain pre-existing rights of others in the real estate, usually consisting of easement rights, rights of tenants under leases and rights of third parties under other written agreements.

For example, a common US real estate transaction consists of the acquisition by an investor of fee-simple ownership of a parcel of land on which is located a multi-floor office building with multiple occupants. In such a transaction, the fee-simple ownership acquired by the investor most likely will be subject to the rights of the occupants of the building under their respective leases and to the rights of providers of electricity, water, natural gas, communications, and other utilities and services to the building under easements granted over the real estate. The real estate may also be subject to certain restrictions on its use provided for in private agreements with neighboring landowners or other third parties. Most often, such third-party rights are viewed as beneficial and provide value to the real estate because they provide income and services to the owner of the real estate and impose orderly-use requirements on both the owner and surrounding landowners. However, certain other rights to which fee-simple ownership may be subject such as liens by providers of materials and services, rights of lenders under mortgages and other security instruments, easements, restrictions and other rights incompatible with a new investor's proposed use of the real estate, are detrimental and should be eliminated before the acquisition occurs.

**Leases and Leasehold Estates**

The concept of an estate in real property originated in England's feudal society, in which all land was owned by the king. The king granted his feudal lords rights to use and occupy certain parcels, of which they in turn gave subordinates rights to use and occupy certain parcels. This system of distribution of rights in land marked the beginning of the modern landlord-tenant relationship. The concept later developed that a person who held such a right did not own the land to which he was granted rights but merely "held" the land. This concept evolved over time into the legal concept of an "estate," which US legal scholars describe as an interest that is or may become possessory and is measured in terms of duration. Fee-simple absolute ownership is an estate that is unlimited in duration. A leasehold estate is an interest, usually granted by a fee-simple owner, that entitles the owner of the leasehold estate to possession of the real estate only for a specified period of time. In its purest form, a leasehold estate entitles its owner, during the duration or "term" of the estate, to all the rights of possession and use of the real estate that are held by the fee-simple owner. Most US leasehold estates, however, are created by lengthy lease agreements that provide in detail for the rights and obligations of the landlord and tenant and for restrictions on the uses and activities that can be conducted on the leased real estate.

Many leasehold estates are created by a ground lease, which is a lease of land, usually undeveloped, on which the tenant has the right to erect buildings or other structures. Under this arrangement, the tenant, during the term of the ground lease, will have fee-simple ownership of the buildings and other structures it erects, and upon the expiration of the ground lease the fee-simple ownership of the buildings and structures will revert to the landlord (unless the ground lease grants to the tenant the right to remove them at the end of the lease term). Ground leases are a useful vehicle for fee-simple owners of real estate who desire to hold their land in connection with long-term financial planning and want to produce income from the land but do not possess either the expertise or the desire to construct and operate income-producing improvements on the land. Ground leases are also commonly used for the development of land owned by state and local governments that want a private party to construct and own facilities they need, or for development or rehabilitation of land that a government is restricted or prohibited by law from selling to a private party. Ground leases are useful to developers of real estate because they eliminate large up-front land acquisition costs.

Ground leases usually have lengthy durations so that development costs invested by tenants can be fully recouped, with profits, over the useful life of buildings or other structures erected on the land. Depending on the type of development proposed, typical terms of ground leases most likely range from 20 to 99 or more years, with 40 to 60 years being common. Most tenants under ground leases will insist, and rightly so, that their leases be "financeable." This requirement entails separate rights in favor of the tenant's lenders to receive written notice of and cure defaults by the tenant under the ground lease, prior to the landlord's taking any action to terminate or cause a forfeiture of the tenant's leasehold estate.

While ground leases serve a useful purpose in US real estate activities, leasehold estates are created most commonly in improved real estate. A lease of improved real estate may cover a parcel of land and all of the improvements on the land, or may cover only a portion of a building located on the land. Many leasehold estates created in both land and improvements are called "triple-net leases," under which the landlord generally has no obligations other than to assure that the tenant's possession of the leased property is not interfered with by third parties. In these types of leases, the tenant has all indicia of ownership, other than legal fee-simple ownership, and is required to perform all responsibilities and make all payments relating to the leased property that otherwise would be the responsibility of the landlord. Under a triple-net lease, the landlord is to receive the rent "net" of costs relating to the real estate, such as taxes, utilities and maintenance costs, all of which are paid by the tenant.

Leases of portions of, or space within, a building, commonly called "space leases," are the most common form of leasehold estates. They are used in buildings with more than one tenant, such as multi-tenant office buildings, shopping centers, industrial parks and apartment buildings. These leases usually require the landlord to provide certain utilities and services (such as electricity, water, heating and air conditioning, general building maintenance, elevator and janitorial services), with the tenant being required to reimburse the landlord on a periodic basis for its *pro-rata* share of these (usually determined by reference to the size of the tenant's leased space).

### Easements and Licenses

Easements and licenses are not estates in land but are non-possessory contract rights in land. While a fee-simple absolute ownership or a leasehold estate in real estate usually entitles the owner to exclusive use and possession of the real estate, the holder of an easement or license has no such rights. Easements and licenses are granted for specific purposes, such as the installation and use of utilities or the use of roadways and accessways. The owner of any estate in the real estate may continue to use and occupy the real estate covered by the easement or license in any manner not inconsistent with the rights granted in the easement or license. Easements and licenses can be either exclusive or nonexclusive, granting a single person or entity, or more than one person or entity easement or license rights in the same real estate.

While not considered estates in land, easements are considered to be interests in land and are usually perpetual in duration although they may, by express terms, be limited in duration. Many easements are granted as an appendage to fee-simple or leasehold estates. Such "appurtenant easements" provide additional rights, such as access or utility services, to benefit the fee-simple or leasehold owner. Easements not granted to benefit a particular parcel of land are commonly called easements in gross, and are usually granted in connection with the provision of public utility or telecommunications services.

Licenses generally are not even considered to be interests in land and are commonly described as the right to enter on the land of another and perform acts that would otherwise constitute trespass. Licenses are usually limited in duration and, if they are not, are revocable by the granting landowner at any time.

## Rules Governing Ownership of US Real Estate — Ownership of Certain Portions of Real Estate

### Air and Subterranean Rights

Generally in the US, the owner of a parcel of real estate owns not only the surface of the parcel, but also all rights to the sky in a direct line above and all rights in the earth in a direct line below the surface of the parcel. The owner of a single parcel may divide these rights into subparcels and convey them separately to others. For example, it would not be unusual for the owner of a parcel of land to retain fee-simple absolute ownership of the surface and the air above the parcel, to a certain height, to construct and operate a shopping center, convey fee-simple absolute ownership of the remaining air rights to another person for the construction and operation of an office or apartment building above the shopping center, grant an easement through a portion of the land lying beneath the surface of the parcel to a governmental entity for the construction and operation of underground mass transportation facilities, and grant a leasehold estate (subject to the easement) of 40 years in the land lying beneath the surface of the parcel to another person for the construction and operation of a parking garage below the shopping center. While not unusual in the US, this transaction is extremely complex and would require comprehensive detailed agreements between the various interest owners to govern the construction on, use and operation of the portions of the real estate owned by each of them, as well as the assistance of a highly qualified engineering firm to properly create the subparcels.

#### Mineral, Timber and Similar Rights

In the US, owners of real estate may also separate and convey independently the rights to the products, called emblements, located on and produced from the real estate. Emblements include crops, timber and rights to extract minerals and other natural resources such as oil, natural gas, coal, precious ores (gold, silver and copper), other metal ores, sand and clay. These emblements are often conveyed by means of farming, timber or mineral rights leases, which are specialized leases that do not grant the full set of possessory rights provided in a customary leasehold estate. These specialized leases often are really more akin to licenses that allow the lessees to enter onto the real estate for a specified purpose. In some states where mining activities are abundant, it is common for rights to oil, gas, coal and other minerals to be owned, sold, conveyed and otherwise dealt with separately from surface rights.

### Rules Governing Ownership of US Real Estate — Types of Common Ownership

#### Tenants in Common

Real estate may be owned by multiple parties through ownership as tenants in common. In this type of ownership arrangement, each tenant in common owns an undivided percentage interest in the real estate. Each tenant in common has the right to possession of all of the real estate, and no tenant in common may use or occupy a portion of the real estate so as to exclude the other tenants in common. Each tenant in common is entitled to receive a portion of the rents, other income and emblements derived from the real estate in an amount equal to its percentage interest in the real estate. A tenant in common may convey or transfer its undivided percentage interest in the real estate to another party without the consent or joinder of the other tenants in common, but the transferring owner cannot legally convey more than its own percentage interest. Tenants in common may choose to enter into written agreements among themselves that govern the use and operation of the real estate and establishes a procedure by which they can make joint decisions relating to the real estate. Because of a variety of legal and practical considerations, however, persons who desire to own commercial real estate jointly are likely to avoid a tenancy in common and form a corporation, partnership, limited liability company or other legal entity.

#### Condominium Ownership

The condominium form of ownership is another type of common ownership of US real estate. Unlike most others, this form of ownership, rather than common law, is created through a statutory scheme. Statutes in each state govern the creation of this type of ownership arrangement. Although different in each state, the process for creating a condominium typically consists of the creation of "units" of space within a parcel of real property by filing certain plats and building plans in the public real estate records. Units thus created are treated for legal and tax purposes as separate "parcels" of real property, and can be sold and conveyed to third parties. The units in a condominium are typically portions of a building that can be occupied as residences or offices, but can also consist of other segregated portions of the real estate. All portions of the real estate that are not units, typically called "common areas," are reserved for the joint use of all the owners of units. Condominium statutes also provide for, and most condominiums include, "special" or "limited" common areas (such as parking areas, balconies and porches) that are reserved for the exclusive use of individual unit owners. Each unit owner in the condominium owns, in addition to its unit, an undivided percentage interest in the common areas.

Condominium statutes typically provide for the preparation and recording in the public real estate records of a written agreement, commonly called a "declaration," that is binding on each person that acquires a unit. The declaration describes the units and the common areas and prescribes a set of regulations for the joint use of the common areas by all unit owners. Most condominium statutes also require the creation of a condominium association, typically a not-for-profit corporation, whose members are the unit owners. The condominium association has primary responsibility for performing the duties relating to the maintenance and operation of the common areas, although it is common for the condominium association to engage a professional management company to actually perform those tasks. The declaration establishes a process for the condominium association to require the unit owners to contribute funds, commonly called assessments, on a *pro rata* basis to pay the association's costs in performing these duties.

## Real Estate Title Records and Title Insurance

### US Real Estate Title Records

As a general rule, the determination of ownership of US real estate is made by an examination of the public real estate records. Typically, each county or city within a state maintains public real estate records pertaining to the real estate within its borders. With very few exceptions, these records are not maintained in any fashion in which all relevant information pertaining to a given parcel of real estate can be easily found in one part of the public records.

When an ownership interest in US real estate is conveyed, the transferee, while not legally required to do so, almost always records the instrument of conveyance in the local public real estate records to provide notice to the public of its ownership. Hundreds of these instruments of conveyance, along with a like number of mortgages and other written agreements affecting real estate, may be filed daily in the real estate records of any county. After the documents are filed, the officials who have responsibility for the public real estate records prepare an index, typically an alphabetical index based on the names of the parties to the documents and the calendar year in which they were filed. To determine the owner of record of any parcel of real estate and the state of the record owner's title to the parcel, an experienced attorney or title examiner must conduct a thorough examination of these indexes and identify who has received the most recent conveyance of title, as well as any other recorded instruments that affect title to the parcel. After the examination is complete, the attorney or title examiner will usually prepare an abstract or certificate of title that contains the name of the record owner and any encumbrances on or other matters affecting the record owner's title. Because of the potential for human error in the indexing and examination of the public real estate records, almost all investors in US real estate now obtain title insurance.

**Title Insurance**

A title insurance policy insures that the condition or state of title to a parcel of real estate is as described in the policy when the policy becomes effective. In exchange for the payment of an insurance premium, the title insurance company agrees to indemnify the insured party against any losses, up to the amount specified in the policy, if the title to the real estate is not in the condition or state reflected in the policy. For example, suppose that after an investor's acquisition of a parcel of real property, a public utility company begins construction of a large electrical transmission line across the parcel under rights granted by a former owner under a recorded easement. The easement rights are not reflected in the investor's title insurance policy because the person who examined the title to the parcel in connection with the issuance of the policy could not locate the easement document due to an indexing error in the public real estate records. In such a case, the title insurance company would be required to pay the investor for any losses, including loss of value to the real estate, incurred by the investor as a result of the existence of the easement.

Title insurance also provides coverage against claims that cannot be revealed by the public records, such as forgeries and unauthorized conveyances. It also provides for the payment of attorney's fees and other costs of defense in connection with any claim, even if the claim is not valid. As with most US insurance policies, the insured must submit a written claim and proof of loss as a condition to the insurance company's defense and payment of any claim. Coverage under a title insurance policy continues for an unlimited time and provides coverage for claims for which the insured party may have legal liability to others even after the insured party no longer owns the insured real estate.

Most title insurance is issued based on standard policy forms and endorsements written and maintained by the American Land Title Association (a trade organization), and is issued in reliance on a comprehensive title examination by an attorney or qualified title examiner. In addition to the basic insuring provisions, each policy excludes from coverage claims arising from certain standard items, such as governmental regulations, police powers, laws governing environmental matters and the rights of creditors. A title insurance policy also excludes from coverage any claims not disclosed by the public real estate records but known to the insured and not disclosed prior to its issuance of the policy.

In addition to the exclusions, each title insurance policy also contains certain exceptions to coverage. These consist of matters affecting title to the insured real estate revealed by the examination of title and certain "standard" exceptions. The standard exceptions generally address certain specified rights affecting title that cannot be ascertained from the public real estate records. Such rights might include, for example, those of any person in possession of the insured real estate under an unrecorded lease or other unrecorded document granting a right of use or possession. Standard exceptions also include boundary line disputes, encroachments and other matters relating to the physical condition of the insured real estate, taxes and governmental assessments not shown by the public records, as well as rights granted by law to persons who have provided, prior to the date of the policy, materials, labor or services to improve the insured real estate. In most cases, the prudent investor can and should negotiate elimination or modification of the exceptions so as to significantly reduce its exposure to claims. In addition, endorsements to the basic title insurance policy are available in most states to provide additional coverage for matters essential to the ownership and use of the insured real estate, such as with zoning laws, compliance with private restrictive covenants, and access.

Title insurance is purchased by payment of a relatively inexpensive one-time premium. Title-insurance premiums in some states, commonly called published-rate states, are established by regulatory officials and companies may not charge premiums less than the published rates. In others, commonly called negotiated-rate states, companies are free to negotiate premiums. For transactions involving multiple properties in both published-rate and negotiated-rate states, a prudent investor will consider engaging the national office of a large title insurance company to issue all of the title insurance policies and will request a substantial reduction in premiums for policies in the negotiated-rate states in exchange for the payment of the higher premiums payable in published-rate states.

## Local Governmental Regulations Governing Development and Operation of Real Estate

Investors in US real estate must concern themselves with numerous state and local laws and regulations relating to real estate. The most common of these pertain to zoning and land, building codes and life-safety requirements, and power of eminent domain. The number and complexity of these laws and regulations tend to be commensurate with the size of the local population.

### Zoning and Land Use

Zoning and land-use laws are enacted and administered by municipalities, townships and counties to regulate the use of real estate within their boundaries. Their purpose is promoting orderly and harmonious development and use of real estate and providing desirable living conditions for residents, while allowing commercial concerns the opportunity to make best use of their real estate interests and minimizing adverse effects on the lifestyles of the residents.

With the exception of some sparsely populated areas, almost every municipality and county in the US has enacted a zoning ordinance, most in conjunction with a comprehensive development plan. The zoning and development plan together have the effect of dividing the enacting community into zones or districts within each of which only certain uses are allowed. Common zones or districts are those that allow the following uses: single family residential (individual homes), multi-family residential (apartment buildings and residential condominium complexes), commercial, office, industrial and mixed use (combination). Zoning ordinances usually differentiate as well within these zones or districts. For example, several types of commercial districts may be established, each of which allows only certain types of commercial activities, separating light and heavy industrial activities. Zoning may also provide for special districts, such as those in which landmarks or historic structures are located or in which the preservation or certain types of development are desired. In addition to providing for permitted uses, a typical zoning ordinance also imposes minimum requirements for each parcel of real estate. Such requirements can encompass a variety of use and development issues, the most common being lot size, density of use, parking, building setbacks, height restrictions, ancillary structures, and front-, side- and rear-yard requirements. Finally, a zoning ordinance may provide for some special (usually controversial) types of uses (such as communications towers, cemeteries, junkyards and landfills) only with a special-use permit, usually obtained from the enacting community only after public hearings and approval by the governing body of the community.

There are two ways in which the use and operation of real estate may not technically comply with the zoning ordinance but is nonetheless lawful. Legal non-conforming uses are uses that were legal at the time the zoning ordinance was created or changed and became illegal as a result of the enactment of or change in the zoning ordinance. A zoning ordinance will usually allow current and future owners of legal but non-conforming real estate use to continue that use until it is discontinued for a specified period of time, or until any structure on the property is removed or destroyed and not rebuilt in substantially the same manner within a specified period of time. A zoning ordinance also typically provides for the granting of variances and special exceptions from the requirements of the ordinance, usually granted to provide relief from requirements that create an unnecessary hardship on an owner because of extraordinary conditions pertaining to the size, shape or topography of the real estate.

Before making any real estate investment in the US, an investor should confirm that the real estate complies with applicable zoning laws. This confirmation may be accomplished by a variety of methods, normally including a combination of the following: written representations and warranties by the current owner; review of current zoning ordinance and public zoning and land-use records by legal counsel; certifications by zoning officials, inspections and reports by qualified engineers and land surveyors; and title insurance coverage. This confirmation process may uncover noncompliance, the nature and degree of which will determine whether it should be of significant concern. A minor encroachment of a structure into a required side yard likely would not present a significant investment obstacle, for example, but a non-conforming or illegal use may be cause for concern. An investor should conduct a careful analysis and seek legal advice to determine whether a noncompliant or non-conforming use should lead it to consider abandoning the proposed investment, or whether rezoning, variance or other remedial action should be undertaken prior to making the investment.

**Building Codes and Safety Requirements**

In almost all areas of the US, improved real estate must comply with local building and life-safety codes. These codes consist of extremely detailed construction requirements for structural components, electrical, plumbing and mechanical systems, interior and exterior finishes and building systems (such as fire alarm and sprinkler systems) and provide for the safety of occupants. Most of these codes are prepared by nonprofit trade organizations (such as the International Code Council), formed by and composed of experts in the real estate and construction industries. Local communities adopt these codes, sometimes with modifications to adapt them to local construction practices.

In most areas in the US, construction of a building cannot lawfully be performed unless the company performing the construction has been issued and maintains in effect a valid building permit. One condition to the issuance of a building permit is approval by certain officials of construction plans and specifications that, if followed, would cause the completed building to comply with the local building codes and life safety-requirements. Once a building permit is issued and construction begins, local governmental officials (commonly called building inspectors) conduct periodic inspections to ensure that the building is being constructed in conformity with the approved plans and specifications and the building codes. A final inspection will determine whether the completed building has been constructed in conformity with the applicable building codes and life-safety requirements and can be lawfully occupied and operated, in which case a certificate of occupancy will be issued. In most US communities, it is illegal to occupy or conduct business in a building for which a certificate of occupancy has not been issued. After a certificate of occupancy is issued, neither the building owner nor any other party may modify the building so as to cause a violation of the building codes. Any such modification could lead to a revocation of the certificate of occupancy if discovered by the local government.

Building codes are frequently modified as a part of a continuing effort to improve construction methods and ensure the safety of structures. Such changes are usually applied to new construction and buildings otherwise in compliance with codes when a change is enacted need not be altered to conform to the change. Such occupancy is referred to as being "grandfathered." If any significant alterations to a grandfathered building are subsequently made, however, it may be necessary for the building to be brought into compliance with the then-current building codes.

Before making any US real estate investment, a prudent investor will confirm that the real estate complies with applicable building codes and life-safety requirements. Since investors are unlikely to have the knowledge or expertise to independently make that determination they should, in addition to requiring evidence of a valid certificate of occupancy, engage a qualified engineer or construction consultant to conduct a thorough physical inspection to determine the extent of any noncompliance.

### Condemnation

In the US, federal, state and local governments, as well as providers of certain public utilities and transportation, have the power of eminent domain. This power (often referred to as condemnation) allows for a "taking" of private property for any public use without the consent of the owner. The process results, in essence, in a forced sale of private property by the owner. The power of eminent domain is commonly used to acquire land needed for highways, tunnels, mass transportation facilities, airports, public utility systems, parks, stadiums, dams and other public infrastructure projects, government office buildings and military installations. In any condemnation proceeding, the condemning authority is required to pay the owner "just and adequate compensation" for the condemned private property. The authority typically will attempt to contact the owner, reach agreement as to the amount of compensation and obtain conveyance in exchange for payment of the compensation. If the condemning authority and the owner cannot agree on the amount of the compensation, however, both federal and state laws provide for the condemning authority to file judicial proceedings in which both it and the owner present evidence of the value of the private property being taken. The ultimate result of these proceedings is a condemnation award (the amount of compensation to be paid to the owner) and the transfer of ownership to the condemning authority. Condemning authorities are required to pay compensation to the owner of each interest in a parcel of condemned real estate including fee-simple and leasehold estate owners, and the holders of easements. Condemnation proceedings are typically recorded in the public real estate records and will be revealed by an examination of the affected real estate's title.

Investors should be wary of investing in any US real estate that is the subject of an ongoing condemnation proceeding. Long before any condemnation proceedings are filed, however, a condemning authority will make known to an owner its intent to exercise its power of eminent domain. Such notification may occur months or even years prior to any proceedings so a prudent investor will also inquire with the current owner of any contemplated investment property whether the owner knows of any proposed but unfiled condemnation action. If the owner has any such knowledge, the investor should require a full written disclosure of all information relating to the proposed action.

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Tim Tucker currently practices as counsel in King & Spalding's Abu Dhabi office and has over 25 years of experience in representing US and international developers, owners, investors, tenants and lenders in all aspects of commercial real estate transactions. This includes the development, acquisition, financing, leasing and disposition of office buildings, shopping centers, hotels, industrial parks, residential apartment and condominium projects, and mixed use developments. Mr. Tucker is a graduate of Vanderbilt University School of Law, where he received his JD in 1982.

# Chapter 17

## UNITED STATES FEDERAL SYSTEM

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The foreign investor acquiring real property in the US will confront a legal and political environment different in many ways from its native system. First and most fundamentally, the US is defined by its federal system. The US Constitution and the constitutions of each of the 50 states allocate governing responsibility among three levels of government — federal, state and local — each of which has three branches — executive, legislative and judicial. This complex structure can adversely impact the costs and efficiency of implementing a real estate investment. Enforcement of the rights of counterparties and competitors through the US judicial system can further frustrate the expectations of the parties and add to the cost of resolving genuine disputes.

### The Federal System

This article provides a guide to the federal system as it relates to real estate investment, operations and taxation. It should not, however, be viewed as exhaustive and results will certainly vary from one state, city or court to another.

The federal system of government assigns to the federal government issues of interstate and foreign commerce, defense and foreign policy, promotion of the general welfare, and taxation to support those activities. Virtually all other governmental powers are reserved to the states and either exercised by them or by local governments created by the states. The Constitution's Bill of Rights also creates a series of national protections which limit federal, state and local laws. For example, the Fifth Amendment provides that property cannot be taken by a government without "just compensation." Zoning resolutions adopted under local law can be challenged in federal court as an illegal "taking" of property without "just compensation."

The result of this system is three levels of government that often overlap and sometimes conflict with each other in regulating various aspects of real estate ownership, operations and taxation. By way of example, federal environmental protection laws set standards and procedures for dealing with air, ground and water pollution throughout the country. Individual states often impose their own additional environmental regulations and may help administer the federal standards. New Jersey, for example, will not permit a transfer of real property until certain environmental assurances have been provided. Similarly, while local governments generally control the physical aspects of real estate construction, federal and state laws that provide protections for persons with disabilities can be enforced against property owners by federal or state agencies and, in some cases by private citizens, to require changes in a building. Using these overlapping bodies of law, private citizens interested in altering, slowing or stopping development of a project may sometimes do so by asserting a failure to comply with such federal or state standards. Even if the effort is unsuccessful, the delays and expenses can seriously reduce the value of a project.

Importantly, each level of government can impose its own taxes on real property. Such taxes may be based on the value of the income derived from, the transfer of or the occupancy of the property.

Sometimes a fourth level of government or sovereignty further complicates matters. Protections provided by the federal government to tribes of Native Americans pursuant to 19th century treaties or trusteeships for the benefit of those tribes have given rise in recent years to great uncertainty as to the limits of state powers and the rights of private-property owners. Tribal lands are governed by the tribe, not by the state in which they are located. Many tribes have permitted the development of gambling casinos on their lands in states which otherwise prohibit casinos. In New York state, several Indian tribes have asserted claims to substantial areas that were tribal lands before having been developed by private individuals. The uncertainty as to ownership of such land has been extensively litigated. The US Supreme Court has confirmed the tribes' rights to sue the state of New York for damages for the taking of their tribal land. Remedies have not been finally determined against persons living in the disputed area. At present, for an additional premium, title insurance companies are providing landowners with insurance against certain title claims by the tribes.

### Local Governments

Within the federal system, the most local segment of government — the county, town, city or village — plays the most direct role in the development and operation of real estate. Development of real estate (and the related need for roads, sewers, water, schools and other infrastructure) is one of the principal functions of local governments (after those related to health, public safety and education). All of the powers of local governments to carry out these functions are derived from the state. The constitution and laws of a state create local governments and grant to them authority to regulate various aspects of real property ownership and development. Such authorities are established by adopting zoning laws to regulate the aesthetics and density of development; adopting building codes to regulate the materials and type of construction; imposing on a development requirements for construction of roads or other infrastructure projects or for preservation of open space; enacting health and fire-safety requirements for sprinklers, fire exits, *etc.*; requiring licensing for bars, restaurants and health clubs; and through various other regulations.

The rate and type of development allowed by local governments can change from one town to the next and one election cycle to the next. One town may restrict office development while its neighbor fosters such development to build its tax base. For any long-term investor, and certainly any investor in a development or redevelopment project, familiarity with the attitudes of the local jurisdiction and its neighbors on these issues is an important part of the competitive landscape. Since development is a local political process, a developer from another state, or even another city, who is not experienced in local matters and connected to the local establishment may face many impediments in obtaining regulatory approvals.

Developers (and investors) from outside the US may face even greater burdens, especially if confronted with strong local opposition to their project. Not being voters, such entities may not fully understand the role of local politics. In some jurisdictions, the fact that a substantial financial interest in a project is owned by a foreign investor can be used by competitors to try to block, delay or limit a new project. Some local governments will require disclosure of the identity, residence and nationality of all owners of a project as part of their zoning and permit proceedings. In xenophobic times when voters in the US feel threatened by foreign competition or war, negative reactions to foreign ownership and development can be strong.

Local governments also can strongly affect the economics of a property after it is in operation. They can do so indirectly by enacting health or safety laws that require capital improvements, such as installation of sprinkler systems or repair of deteriorating facades, and they can affect a property's economics directly by restricting a landlord's ability to raise rents. For many decades, New York City's rent-control laws have limited or blocked increases in rents for residential real estate on the theory that there has been a significant shortage of housing and the government did not want landlords to take advantage of tenants. Those laws have continued long after the original crisis passed because tenant groups became a powerful political force in their efforts to protect their rent-control benefits. The resulting significant deterioration of housing stock has begun to be remedied only in recent years with the relaxation of rent control. Emergency price controls may be enacted at the federal and state level as well — although they generally do not control rents.

Finally, local governments tax real property as a significant source of revenue. In general, the tax is based on the value of the land and improvements rather than its net income or revenues. Often distinction is made between developed and undeveloped land, including farm land. The assessed value of a property may go unchanged for years, resulting in artificially low taxes for a particular property owner, but a transaction such as the sale, significant redevelopment or alteration of a property can trigger a reappraisal and a significant increase in real estate taxes. Some large cities, such as New York, may have state authorization to impose income tax as well as property tax, but most income taxes are imposed at the state and federal levels.

## State Governments

Except in cases reserved to the federal government by the Constitution, state governments have the ultimate authority to govern the use, development and operation of real estate. As noted above, much of this authority has been delegated to local governments although the power of the purse generally is retained by the state. Many states impose transaction taxes on the transfer or mortgaging of real property, and some allow local governments to do so as well. Occasionally, the transfer tax burdens are so significant (as in the case of New York's former 10 percent tax on proceeds from the sale of certain real property) that transactions are frustrated and alternative devices for transferring economic benefits are invented. The game of cat-and-mouse continues as tax authorities expand regulations and businessmen create new escapes. An infinite variety in the form of transactions has resulted to avoid or limit tax burdens. This variety includes ground leases, transfers of beneficial interests, and allocations of purchase price between real and personal property.

Sometimes, when a transaction tax is significant but cannot be avoided, the parties take unusual measures. Several years ago, a lender made a loan of approximately $1 billion secured by the Rockefeller Center office complex in Manhattan. The mortgage recording charges, customarily paid by the borrower, were extremely high. The lender made the unusual decision not to record its mortgage in order to avoid the recording tax, obtaining other protections from the borrower and saving the borrower the recording costs.

States also impose taxes on net income derived from real estate projects, using laws generally modeled on the federal Internal Revenue Code, but at rates widely differing from state to state.

Each state regulates the manner in which ownership of real property is conveyed and how it is reflected on the public records. Laws govern the priority of liens such as those for unpaid taxes, mechanic's and materialman's liens that protect contractors, and liens associated with mortgages or deeds of trust, and they govern the remedies available to lienholders. States also regulate the terms on which title insurance is sold in the state. Such matters may be governed in widely different manners from state to state.

Subject to federal and state constitutions, state governments also have the authority to regulate the ownership of real estate. In the past, states have passed laws prohibiting ownership — often specifically of farm land — by persons who are not citizens or residents of the US. A number of states, particularly in agricultural areas of the South and Midwest, still restrict ownership of farm land by foreign investors. Generally, the limits relate to the number of acres or the time period for which foreign ownership is permitted. A revival of xenophobia can result in the passage of laws that tighten foreign-ownership restrictions, as occurred in the 1970s. However, the US Constitution prevents the passage of laws which take away pre-existing property rights of owners without due process and just compensation, and those protections are available to foreign investors. Even with constitutional protections, however, the hysteria that can accompany a war or similar animosity between nations can impair the foreign investor's enjoyment of its property rights. We will see later how the federal government has played a significant role in regulating foreign ownership.

Each state, as well as the federal government, regulates the offering of securities such as shares in REITs or investment partnerships or cooperative apartments. State rules generally follow federal definitions and exemptions. In addition, some states — New York is one — separately regulate the offering of interests in certain real estate securities. The sale of residential property as cooperative or condominium units or single-family homes also may be regulated at the state level. Certain states — California is one — have passed laws to restrict development in coastal areas so as to protect their natural environment. Such state laws generally override those of local governments.

Beyond its capacity to regulate and tax real estate, each state also has the power to take land from private owners. The general parameters of this power are governed by the Fifth Amendment to the federal Constitution, which allows taking of private land for a public use only upon payment of "just compensation." The purposes for which such takings may be permissible can include highway expansion and urban redevelopment projects. Cases before the US Supreme Court have addressed the extent to which other state and local actions, such as zoning, can amount to a taking and require just compensation.

### The Federal Government

Federal regulation of real estate is often indirect since only certain jurisdictions, including interstate commerce and navigable waterways, are reserved to the federal government. Federal laws that protect some broad national interest may nevertheless have a great impact on local real estate development. The following are examples.

- Environmental laws such as the federal Comprehensive Environmental Compensation and Liability Act (CERCLA) and Resource Conservation and Recovery Act (RCRA) (as well as their state equivalents) impose significant burdens on owners of land that has been polluted with hazardous substances. If the owner or operator of a property creates or allows environmental hazards on the property, the owner, the operating entity, and in some circumstances, the individual manager of the entity, may be exposed to liability to the government for clean-up costs and damage to natural resources. These statutes also give individuals injured by a hazardous substance the ability to sue for compensation for their injury.
- Laws protecting the rights of disabled persons affect the design of properties, often mandating ramps, elevators and specially outfitted bathrooms to provide wheelchair accessibility.
- The development of riverfront or beachfront properties may be subject to the control of the United States Army Corps of Engineers over navigable waterways, including wetlands; and may be benefited or burdened by dredging, dams and erosion-control projects.
- Federal regulations protecting endangered species can delay or prohibit development of real estate that includes a protected habitat.
- Federal laws relating to preservation of historic landmarks can impose significant development restrictions on properties designated as landmarks. Conversely, federal tax laws give benefits to owners who improve landmark buildings. Since landmark buildings are generally smaller than what would otherwise be permitted under local zoning laws, many center-city towers have been built with the unused development rights associated with the site of a landmark building and may even be attached to the landmark building. The Palace Hotel in New York is a prime example.
- The Interstate Land Sales Act regulates sales of homes and condominiums.
- The Trading with the Enemy Act has been applied in times of war to deprive a foreign investor of control and ownership of US property if the foreign investor is from a nation that has become an "enemy" of the US. More recently, the International Emergency Economic Powers Act has been applied to freeze assets of foreign investors who were nationals of adversaries in the Persian Gulf War. These rules apply to assets of all types, including real property. A foreign investor can challenge such laws in court, but even a successful outcome can mean little if it takes years to achieve and the value of the property has been impaired in the interim. Some foreign investors have erected legal structures, based on US trusts and migration of entities, which may help deflect the impact of such laws.
- Federal securities laws regulate the sale of securities such as stock in corporations, interests in limited partnerships and limited liability companies, and other investment contracts in which an investor is dependent on the management skills of a promoter. The laws are designed to protect the passive investor and generally require registration of the securities being offered and of the persons marketing them. Registration of securities involves disclosure of the investment and its risks, and those involved in the offering can be held responsible for any misstatements or omissions of material facts, as well as for any fraud. Federal securities laws do not, however, regulate the quality of an investment.

  A securities investment by a small number of knowledgeable and or wealthy investors is exempt from registration as long as technical requirements of the exemption are satisfied. In such event, the investor is generally required to make representations and warranties to the promoter to provide assurance that the exemption is available. Registration of securities offered and sold outside the US may also be exempt if adequate precautions are taken to limit resale in the US. These exemptions do not extend to the anti-fraud provisions, however.
- The Department of Commerce collects information on direct investments by foreigners in the US. Such investments include the acquisition of real property or of interests in private entities that own real property. The reports, filed with the Bureau of Economic Analysis of the Department of Commerce, include the amount invested and the country of origin, but not the name, of the ultimate beneficial owner (the owner all the way up

the ownership chain). Reports must be filed periodically until the investment is disposed of. The Bureau is prohibited from making the reports available to the Internal Revenue Service or any other governmental body. The federal Department of Agriculture also requires similar reports from foreign owners of farm land.

- The greatest impact the federal government has on real estate investment is through its tax laws. The federal government taxes net income derived from the ownership and sale of real property. It allows the deduction from taxable income of non-cash expenses for depreciation and the recapture of those costs as additional income upon the sale of such property. Changes in these laws can greatly affect the after-tax value of an investment. Lower capital-gains tax rates benefit a long-term investor, while higher ordinary-income tax rates will apply to developers of single-family homes and condominiums who sell their property as inventory.

  The real estate investment trust (REIT) form of ownership is a creature of federal tax laws. The REIT arises from an exemption from taxes for certain widely-held real estate investment entities that distribute substantially all of their rental income to their owners. The exemption generally has not been available to development companies, however, so complying with the REIT tax requirements can often result in strange operating and ownership structures.

  Partnerships and limited liability companies are also entitled to special treatment under federal tax laws. They are transparent for tax purposes and their net income is taxed to their members or partners. All of these laws and benefits involve intricate requirements and rules, which can often result in traps for the unwary.

  The federal government negotiates tax treaties with other countries that significantly affect the rate at which dividends, interest and other distributions to foreign investors are taxed by the US. The Foreign Investment in Real Property Tax Act (FIRPTA) taxes foreign persons on their net gain from the sale of their interest in US real property, including the sale of shares of US corporations whose principal assets are US real property. The branch-profits tax imposed on foreign corporations tends to push foreign investors to hold real estate investments through entities organized in the US. Rules regarding offshore leveraging restrict the deductibility of interest paid to affiliated foreign lenders. The list is nearly endless.

## Litigation Concerns

Another distinguishing feature of the US investment landscape is the role of litigation, used in the US as elsewhere to resolve disputes. But litigation is also used frequently as a tactical device — to delay the issuance of building permits or the foreclosure of a mortgage, or to coerce an adversary by escalating costs for a financially weaker opponent. Time and again in New York City, for example, the development of a high-rise building will stimulate litigation by adjacent property owners who assert that zoning technicalities have not been satisfied, that the environmental impact has not been properly assessed, that the construction poses dangers to the citizens — all in an effort to protect their view of the skyline and the quiet of their neighborhood or to thwart competition. Such activity adds to the cost of development and has spawned the emergence of lawyers who are expert in these battles.

Chapter 28 addresses in detail the role of litigation, and of bankruptcy litigation in particular, in enforcing or disrupting the expectations of the parties. Courts in the US use a common-law system that treats each set of facts as unique and builds rules of law from a random series of court decisions that can differ greatly from state to state. This common-law system introduces a level of uncertainty as to what meaning a particular court will give to the terms of an agreement when viewed in light of a specific set of circumstances that may not have been clearly contemplated when the agreement was written.

In response to this uncertainty, lawyers in the US tend to document their transactions in great detail with the hope that by addressing each possible circumstance they will remove most of the ambiguity about their client's intentions. But this tendency adds significantly to the bulk, detail and density of the documents, which often become heavily negotiated under great time pressure. As a result, the documents can contain provisions which may later be found to contradict one another — undermining the intended certainty and increasing rather than reducing the likelihood of litigation. Of course the drafting and review of such documentation adds significantly to legal costs, far beyond those usually encountered in other countries.

The US federal system creates a very intricate web of laws, regulations and authorities, often overlapping and sometimes contradictory, particularly in their application to real estate investment. Other chapters in this guide will address the myriad ways this federal system affects the development and operation of real estate and impacts the foreign investor.

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# Chapter 18

## REGULATIONS GOVERNING FINANCING AND SECURITIES ACTIVITY IN THE US

James Richman, Arnold & Porter LLP

If an international investor acquires a direct equity interest in US real estate using its own funds, it will generally be able to do so without reference to US laws and regulations related to financing. However, if an investor raises equity money or is a borrower or a lender in connection with its investment transactions, laws and regulations applicable to equity and debt financing will govern such transactions. In that case, the investor may have to address federal, state and local legal requirements. Although an investor should retain legal advisors for each investment to deal with these requirements, this article sets forth an overview of the legal framework.

### Equity Financing — Securities Laws Affecting Real Estate Transactions

The US has a very complex and detailed body of law governing the issuance and sale of securities. Violations of these laws can have a variety of consequences, ranging from rescission rights and administrative censure to civil and criminal penalties, often involving fines and or monetary damages. The Securities Act of 1933 is the primary US securities law affecting investments in real estate, but other federal or state laws may have relevance to a particular transaction.

#### Securities Act of 1933

The United States Securities Act of 1933, as amended (1933 Act), has two primary purposes: to allow investors to receive financial and other significant information concerning the securities being offered and to prohibit deception and other fraud in offerings to the public. With certain exceptions, the 1933 Act regulates principally transactions involving the sale or resale of securities. The disclosure of important financial information through the registration of securities is the principal way the Securities and Exchange Commission (SEC) accomplishes these goals. Information contained in registration statements allows investors to make informed judgments regarding their investment in a company's securities. The SEC requires that the information provided in registration statements be accurate and free from material misstatements or omissions, but the SEC does not guarantee or authenticate the disclosures. Section 5 of the 1933 Act makes it unlawful for any person to sell a security in the US unless there is an exemption from registration or a registration statement is in effect with the SEC. "Security" is defined broadly in the 1933 Act and by case law. It is well established that in addition to equity and debt interests in traditional widely held public corporations, offerings of interest in private companies, limited partnerships, limited liability companies and trusts may constitute a sale of securities to which the 1933 Act applies.

Generally, the 1933 Act is not applicable to offers and sales of securities outside of the US, so raising money abroad for investment in the US is normally not subject to US securities laws. However, various aspects of a transaction for raising equity to invest in US real estate need to be carefully considered to confirm that the offerees and the jurisdictions in which the offer and the sale are made keep it outside of the 1933 Act, since any offer to US residents would trigger regulation under US securities laws. Further, anti-fraud and other provisions of the federal securities laws may have limited applicability to securities offered and sold outside of the US.

The requirement to register any non-exempt offering of securities in the US means that a registration statement must have been filed with the SEC and declared effective by the agency. It is unlawful to publicly offer or sell securities until such a registration statement is in effect.

There are three commonly used exemptions from the registration requirements of the 1933 Act. First, Section 4(2) exempts transactions by an issuer of securities not involving any public offering. This exemption is limited to sales of securities by the issuer. Any resale of the security by someone other than the issuer must independently satisfy an exemption from registration before it takes place, or must be registered. Judicial and administrative rulings have established that a transaction does not involve a public offering if it is made to a limited number of selected persons and not pursuant to a general solicitation of the public, if the securities are sold to investors sophisticated in business matters or able to obtain the type of assistance that will enable them to make informed investment decisions and if, prior to the purchase of the securities, the investors are given or provided access to information similar to that which would be available if the securities were registered. Such exemptions are granted based on the facts and circumstances of the individual offering, however, so it is important to carefully structure the transaction to fit into the general parameters of the exemption.

Second, Regulation D of the 1933 Act provides several safe-harbor exemptions from the registration requirements of Section 5 of the 1933 Act. The most commonly used of these is Rule 506, which allows an issuer meeting its requirements to raise an unlimited amount of capital by issuing securities to certain types of investors (a "Rule 506 Offering"). Rule 506 limits the sale of a security to no more than 35 purchasers, excluding "accredited investors." Accredited investors generally include institutional investors such as banks, insurance companies, private equity funds, venture capital funds and investment companies, as well as high-net-worth individuals. Purchasers must be provided the opportunity to ask questions and receive information regarding the terms and conditions of the offering before purchasing the securities. Although it is not required, the issuer frequently provides a private-placement memorandum that discloses information about the issuer and the securities. This information may include financial statements, risk factors and other information about the offering.

A third exemption from registration involves intra-state offerings. The 1933 Act exempts from registration purely local offerings, which are those made by an issuer resident and doing business in the same state as the residents to which the securities are offered and sold. This exemption can be used as often and for any amount of money the issuer desires. The issuer — corporation, limited partnership, limited liability company or trust — is a resident of the state where it is organized.

The issuer is doing business within the state if it derives 80 percent of gross revenues within the state, holds 80 percent of its assets in the state, uses 80 percent of net proceeds from the sale of the securities in connection with real property in the state, and the principal office of the issuer is in the state. Residency of an individual purchaser can be determined by his or her actual residence, and a corporation, partnership, limited liability company or trust purchaser is a resident of the state where it has its principal office. Issuers and purchasers utilizing the intra-state offering exemption must be careful to comply with residency requirements as well as with the resale restrictions on these securities so as not to violate securities laws and adversely affect the transaction's exemption. Exemption from the registration requirements of the 1933 Act avoids a costly and time-consuming process, although the securities are still subject to anti-fraud provisions of the Act. Any materials provided to investors, including responses to their inquires, must not be false or misleading. The tests for compliance with Section 4(2), Regulation D and the intra-state offering exemption are factually driven and any investment scheme must be carefully reviewed to make sure that it complies with the conditions imposed by these exemptions.

### Other US Securities Laws

In addition to the 1933 Act, other securities laws may have an impact on the financing of real estate transactions in the US.

#### *Securities Exchange Act of 1934*

Unlike the 1933 Act, which focuses on the sale of securities, the Securities Exchange Act of 1934, as amended (1934 Act), regulates all aspects of securities transactions, including ongoing public reporting by companies, the operation of trading markets and the activities of broker-dealers.

Generally, securities must be registered under the 1934 Act if they are traded on a national exchange (such as the New York Stock Exchange), or if the issuer's total assets are in excess of $10 million and any class of the security is held by at least 500 people. Any company that registers an offering under the 1933 Act will also be subject to public reporting under the 1934 Act for at least one year.

If registration is required under the 1934 Act, the issuer must file a detailed registration statement, annual and quarterly reports, and must file reports throughout the year to disclose certain material events. These last reports generally must be filed within four days of the events being reported. In addition, the 1934 Act may regulate the solicitation of consents and proxies from investors and may restrict directors, officers and certain "insiders" from engaging in certain trading activities. "Insider trading" is illegal when a person buys or sells a security while in possession of material, non-public information which he or she has a duty not to disclose which precludes him or her from purchasing or selling affected securities.

#### *Trust Indenture Act of 1939*

The Trust Indenture Act of 1939 (Trust Indenture Act) requires that the offering and sale of a debt security meet certain trust indenture requirements. It does not apply to privately placed securities exempt from registration under the 1933 Act. A qualified indenture must contain, among other things, information regarding the eligibility and qualification of trustees, any preferences in the collection of claims against the obligor of the security, opinions of counsel, officers and accountants regarding the indenture, and information regarding the duties of the trustee prior to default and upon the occurrence of default.

***State Regulation of Securities***

Not only must securities comply with federal securities laws and be registered with the SEC under the 1933 Act, but each state imposes restrictions on the issuance or resale of securities under "blue-sky laws." Typically, laws require registration of non-exempt securities and prohibit fraud in connection with the offer or sale of securities.

The 1933 Act prohibits a state from requiring the registration or qualification of any "covered securities," meaning those exempt from registration under Rule 506 of Regulation D. When a security is not "covered" under the 1933 Act, it is subject to state registration requirements and the state may require its registration unless an exemption from registration in the state exists. Each state may impose its own requirements for securities offered or sold in the state, and a careful analysis must be made early in the offering process to determine which states' laws affect a particular offering and the timing of applicable filings and payments. Although adoption of some form of the Uniform Securities Act has provided some degree of uniformity among several of the states, "blue-sky" laws are often uncoordinated and sometimes conflicting.

## Debt Financing — Security Instruments and Lender Remedies

Notwithstanding Shakespeare's admonition to be neither a borrower nor a lender, many large real estate transactions are financed using leverage. An international investor may elect to lend money in connection with a US real property investment for any number of reasons including US or foreign tax treatment that is more favorable for income arising from interest payments on debt than for dividends, the seniority of the lender's positions over holders of equity securities, or out of a preference to have lender's remedies govern its relationship with a local transaction participant providing construction or operational expertise.

Alternatively, an international investor may choose to be a borrower and obtain debt financing to limit its capital commitment, to enhance a transaction's yield, or to provide for a more favorable structure for the raising of money to invest in the transaction. Whether a borrower or a lender, an investor needs to have some familiarity with the laws that may affect its rights and obligations, and its ability to protect its interest in the event of a default or insolvency.

Any loan transaction involves a number of documents. Typically, a loan commitment or term sheet sets forth the basic terms of the loan. The term sheet may or may not be binding on the parties. A loan agreement sets forth the terms and conditions for the funding of the loan and often imposes additional contractual obligations on the lender and the borrower. The indebtedness is evidenced by a bond or promissory note that contains the borrower's agreement to repay the debt and the maturity date, payment terms and interest rate(s) of the loan. Although less common in commercial transactions involving sophisticated borrowers, some states continue to have usury laws that govern the amount of interest that can be charged. In a loan transaction it is necessary to review these to determine if there is an interest limit and, if so, what fees and other charges are included in the calculation of interest.

The promissory note merely contains the promise to repay the loan upon particular terms, but most real estate loans are not extended based solely on the credit of the borrower. Instead, they are based, at least in part, on the value of the real estate and associated real and personal property rights, which are pledged as security for the repayment of the loan. The mortgage or deed of trust is the principal security document that achieves this. In addition, there would normally be an assignment of leases and rents to assign the income from the real property, and a security agreement and financing statements that assign associated personal property.

## Mortgage

The mortgage is a hybrid document in that it both contains contractual provisions and conveys an interest in the real estate security. It generally provides undertakings on the part of the borrower intended to preserve the value of the real estate and protect the lender from actions by the borrower or others that may adversely affect the likelihood of repayment. In addition, it conveys a current interest in the real property to the lender or a trustee. The terms mortgage and deed of trust are often used interchangeably with respect to real property security, but technically they provide for slightly different relationships between the borrower and the lender. In a mortgage, the borrower is the mortgagor and conveys an interest in the real property to the lender as mortgagee. In a deed of trust, the borrower conveys an interest in the real property to a trustee for the benefit of the lender. In either event, the mortgagee or trustee holds the security interest in accordance with the written instrument and is obligated to re-convey that interest to the borrower when the loan is repaid in accordance with its terms. In the event of a default by the borrower, the mortgagee or trustee has the right to foreclose on the property and sell it to recover the amounts owed by the borrower. Historical differences in their evolution have produced the two types of security instruments, but today the effect on the borrower and the lender is not substantially different.

Local law governs the required contents of the mortgage and the procedures for foreclosure of the security interest created by it. Generally, foreclosure is the process by which the holder of a mortgage enforces its loan by causing the property that serves as security for the mortgage to be sold, free and clear of subordinate interests in such property, and the proceeds from such sale to be distributed to the mortgage holder. Individual states have statutes and regulations, and in some cases local jurisdictions have rules and regulations, governing foreclosure. In most jurisdictions, there is a customary or preferred form of mortgage, but some jurisdictions permit the use of either a deed of trust or a mortgage.

In order for the security interest created by the mortgage to have priority over other interests in the property, a thorough search must be performed of all instruments recorded against the property in the land records of the jurisdiction in which the real property is located. Typically, such a search is performed by a title company at the borrower's expense. Interests recorded prior to the recordation of the mortgage will have priority over the security interest created by the mortgage, so the lender may require the borrower to secure the release or subordination of some or all such interests. In order for the security interest created by the mortgage to be perfected, it must be properly recorded in the land records and any applicable taxes or fees must be paid.

## Lenders' Remedies: Mortgage Foreclosure

In the event of a loan default by the borrower, the lender will seek to realize on its security. Each state has procedural requirements applicable to such a proceeding and they may not be the same for a mortgage and a deed of trust. Foreclosure may occur pursuant to a judicial procedure or, in some states, pursuant to a power of sale in the mortgage. Foreclosures taking place pursuant to a power of sale generally require written notice to the borrower and other parties having a record interest in the security property (such as subordinated lenders) prior to exercising remedies. Judicial foreclosures involve filing an action in the applicable court naming the borrower, the legal owner and others having an interest in the security property. In addition, the state's procedural statute or rules generally provide for public notice to other interested parties, usually by public advertisement in a local newspaper of general circulation and setting forth the place and terms of the sale. The content of the notice, the types of publication, and the number of times that the advertisement must run are provided for in the court order or statute and regulations. The auction will follow the advertisement and the property will be sold to the highest bidder. The proceeds of the sale will be subject to an accounting and will be applied to pay for the costs of the sale and then distributed to the parties having an interest in the property in their order of priority. Any proceeds that remain following the satisfaction of all prior claims are distributed to the borrower. In many jurisdictions, an accounting must be filed in court for ratification of the sale and the distribution of the proceeds. A failure to follow all of the requirements may result in the foreclosure sale being overturned.

### Uniform Commercial Code

As additional security for the loan, a lender will generally require that the borrower enter into a security agreement pledging to the lender contractual rights and personal property related to the real property, as well as the rental and lease income from the real property. Although a security interest in the personal property is created by the security agreement (or perhaps the mortgage), it is necessary to file a financing statement (pursuant to the Uniform Commercial Code (the Code)) to perfect such interest and obtain priority over any interests created subsequent to the security agreement.

The Code applies not to security interests in real property, but those in personal property. Certain types of property, however, such as liens on motor vehicles, are outside the Code.

A security interest is created when four requirements are met: the parties must enter into the security agreement to "provide for or create in" the secured party the intended security interest (and the security agreement must reasonably identify the collateral to which the security interest will attach), and the borrower must sign the security agreement. Third, the borrower must have rights in the secured collateral. Finally, the lender must give value to the borrower. When these four requirements are met, the security interest has "attached" to the collateral.

Once the security interest is created, it is perfected by filing a financing statement (required by the Code) that provides notice to other creditors that the security interest has priority over later-created interests. Upon perfection, the security interest general is protected against claims of competing creditors subsequently created.

As with the recordation of a mortgage in the land records, the filing of a financing statement in the appropriate state files should be preceded by a search of the state files for pre-existing security interests. The lender may require the borrower to secure the release of any security interests that would otherwise have priority over the lender's security interest. Some version of the Code has been adopted by every state. It is necessary to review the Code to determine the required content of the security agreement and financing statement and to determine where the financing statement must to be filed.

A separate filing may be necessary to perfect a security interest in fixtures, which are items of personal property annexed to real property in such a way as to become part of the real property. Fixtures usually include vital components of the buildings, such as HVAC and sprinkler systems. A "fixture filing" in the office where the mortgage was filed will secure these items.

Security interests are not limited to tangible personal property. A creditor may also take a security interest in the shares, partnership interests or membership interests of the debtor entity that owns the property being financed.

### Possession of the Real Property

After default, a lender may lawfully acquire possession of the real property, directly or through a receiver, while the mortgage still exists. Courts generally allow a lender to possess the real property until the borrower redeems it or it is foreclosed. Under the law of most states, however, possession by the lender is not a matter of right but the result of a court's allowing an entry by the lender on the property prior to foreclosure if the borrower consents or if the court enters such an order. Such consent by a borrower will commonly be included in the mortgage. Should the lender take possession of the property prior to the foreclosure, it has the obligation to account to the court for the rents and profits received from the property and to face potential liability for waste or mismanagement of the property before foreclosure. The lender will be liable for injuries suffered on the property due to its actions or failure to act, and is also responsible for maintenance of the property. Unless there is a real threat of waste to the property, the risks associated with being a lender in possession keep most lenders from taking possession except under direct court supervision or through a receiver. In a contested foreclosure, however, where there is a potential for delay in obtaining the property or its income, the lender may seek the appointment of a receiver by the court.

## Deficiency Judgment

A lender may seek to recover a mortgage debt either by suing on the note or other evidence of indebtedness, obtaining a judgment and seeking to enforce the judgment against any property of the debtor, or by foreclosing on the mortgaged property. Many commercial mortgages do not offer recourse, by their terms or by applicable law, which means the debt is secured by the property only and the borrower is not personally liable for the debt. In such cases, the lender may not have an effective remedy against other property of the debtor.

Even in the case of a non-recourse mortgage, however, a lender will try to retain the ability to sue the debtor personally for certain acts such as waste, fraud or the violation of environmental or other regulatory schemes applicable to the property. These "non-recourse carve outs" allow the lender to take action against the debtor for damages without respect to recovery against the property. If the mortgage is non-recourse, most states allow the lender to foreclose on the mortgaged property and then obtain a judgment against the borrower if the proceeds of the sale are insufficient to satisfy the debt secured by the property. A deficiency judgment entitles the creditor to recover the difference between the foreclosure sale price and the loan amount. Some states apply a "one-action rule," which provides that in the event of a default, the lender may pursue only one remedy in such a situation. The rule may also mean that the lender must enforce its loan only by foreclosing against the security first.

## Bankruptcy

Without addressing all of the provisions of the federal laws governing insolvency, this section will focus on the fact that the rights of the borrower and the lender may be significantly affected if a bankruptcy is filed by or against the borrower. The rights of both the borrower and the lender with respect to the property and its income will be subjected to the actions of the bankruptcy court.

The automatic-stay provision has the most immediate impact on the lender. When a bankruptcy is filed, both judicial and non-judicial proceedings against the borrower and its properties are stopped even if a foreclosure proceeding has already started. The stay is not subject to court review and attaches immediately. A foreclosure may not continue until the automatic stay is lifted. The borrower or a trustee approved by the bankruptcy court will operate the property as a fiduciary of the bankrupt estate and all of the creditors, and no creditor will be able to pursue remedies against its collateral without the approval of the court.

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James Richman, a partner with Arnold & Porter, has negotiated a wide variety of real estate deals, including the purchase and sale of commercial properties; acquisition of land and joint ventures for development; real estate loans; leases; design and construction contracts; workouts; and land use entitlements. He is a graduate of the University of California, Boalt Hall School of Law, was the chair of the Los Angeles County Bar Real Property Section, and serves on the Executive Committee of the California State Bar Real Property Law Section.

# Chapter 19

## BANK SECRECY ACT (PATRIOT ACT) AND OFAC OBLIGATIONS

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The Bank Secrecy Act, as amended (BSA), establishes a comprehensive regulatory framework designed to protect the US financial system through the prevention, detection and prosecution of money laundering and the financing of terrorism. It places obligations on financial institutions, which generally are the entities in the best position to effectively identify and guard against these abuses. The term financial institution is broadly defined under the BSA, so much so that BSA obligations reach beyond insured depository institutions and generally apply to all institutions that deal in cash, securities or similar assets readily convertible into cash. Because the statutory definition of financial institutions specifically includes persons involved in real estate closings and settlements as well as investment companies, it is very likely that a foreign investor in US real estate will be subject to certain of the BSA obligations. These obligations arise in addition to those described in the economic and trade sanctions laws administered by the Treasury Department's Office of Foreign Assets Control (OFAC) as falling to "all US persons."

In order to assist the foreign investor in navigating this complicated and continually evolving area of US law, this chapter provides the following:

- a short discussion of the BSA and its general implementation
- a discussion of pending and existing BSA obligations applicable to "persons involved in real estate closings and settlements" and unregistered investment companies
- a discussion of existing OFAC obligations
- recommendations for "best practices."

### Bank Secrecy Act

The Currency and Foreign Transactions Reporting Act of 1970, better known as the Bank Secrecy Act, was enacted by Congress to prevent banks and other financial services providers from being used as intermediaries for, or to hide the transfer or deposit of money derived from, criminal activity. In its original form, the BSA was designed to facilitate the detection and investigation of criminal, tax and regulatory violations by creating a system of reporting requirements to help identify suspicious and unusual currency transactions.

Over the years, the BSA has been amended a number of times to broaden its purpose and enhance its effectiveness. The most significant of the amendments, particularly for investors in US real estate, is the act titled The Uniting and Strengthening America by Providing Appropriate Tools to Restrict, Intercept and Obstruct Terrorism Act of 2001 (the Patriot Act). Enacted following the September 11, 2001 terrorist attacks on the US, the purpose of the Patriot Act is to enhance the prevention, detection and prosecution of international money laundering and the financing of terrorism. Specifically, the Patriot Act criminalized the financing of terrorism and enhanced the existing BSA framework by requiring the implementation of programs against money laundering, strengthening customer-identification procedures, and improving information sharing between financial institutions and the US government.

In its current form, the BSA imposes obligations on financial institutions to report certain currency transactions, to report certain suspicious activity, to develop and maintain anti-money-laundering and customer-identification programs, and to share certain information. The BSA grants the US Treasury Department (Treasury) the authority to implement the statute. Treasury has delegated this authority to its bureau titled the Financial Crimes Enforcement Network (FinCEN). Among other responsibilities, FinCEN issues and interprets, as well as supports and enforces, BSA regulations.

As noted above, the term financial institution includes businesses that deal in cash, securities and other types of assets that can readily be converted into cash. The definition obviously includes banks, thrifts, credit unions and registered broker-dealers, but also entities not generally subject to federal financial regulation, such as insurance companies, money service businesses, and loan and finance companies. Importantly for foreign investors in US real estate, the definition further includes "persons involved in real estate closings and settlements" and unregistered investment companies.

Under its delegated authority, FinCEN has the authority to determine whether to apply various BSA obligations to each of the specified financial institutions and, to date, has chosen not to impose general currency transaction reporting or suspicious activity reporting requirements on either "persons involved in real estate closings and settlements" or on unregistered investment companies. However, as further discussed below, FinCEN continues to consider whether these financial institutions should be required to develop anti-money-laundering and customer-identification programs. These considerations include how best to define what institutions should be subjected to the requirements (not directly addressed in the BSA) and whether the institutions are likely to be abused by money launderers.

**Pending Anti-Money-Laundering Obligations**

Section 352 of the Patriot Act requires all financial institutions to establish anti-money-laundering programs that include internal policies, procedures and controls, a designated compliance officer, an ongoing employee-training program and an independent audit function to test the program. The provision permits Treasury to prescribe minimum program standards and to exempt financial institutions not otherwise subject to regulation under the BSA.

FinCEN has temporarily exempted certain financial institutions from compliance with this provision while it studies the money-laundering risks posed by each so as to develop appropriate anti-money-laundering program requirements. It also has taken some initial rulemaking actions with respect to "persons involved in real estate closings and settlements" and unregistered investment companies. Following the appointment of a new director in mid-2007, however, FinCEN opted to take a "fresh look," and efforts to finalize rules were terminated. On July 21, 2009, citing concern over the abuses in the residential mortgage markets, FinCEN issued an advanced notice of proposed rulemaking seeking comment on the possible imposition of BSA obligations on non-bank residential mortgage lenders and originators. While FinCEN has determined it will defer regulation of other types of finance businesses, including commercial real estate businesses, until further research and analysis has been completed on the risks posed by these businesses, FinCEN has indicated its intent eventually to require anti-money-laundering programs for all types of loan and finance companies. As a result, it may be useful to review these rulemaking efforts to determine possible impact on foreign investors in US real estate.

***Unregistered Investment Companies***

The BSA names, but does not define, investment companies, and the legislative history does not provide any guidance as to Congress' intent. Investment companies not registered under the Investment Company Act of 1940, therefore, are temporarily exempt from FinCEN's anti-money-laundering program requirements.

In September 2002, FinCEN proposed anti-money-laundering program standards for unregistered investment companies. The proposal sought to define "unregistered investment company" and set forth program requirements similar to those for registered investment companies. Importantly, FinCEN sought to include, among other business entities, private equity funds, venture capital funds and real estate investment trusts. In order to include only those entities likely to be used in the money-laundering process, the proposal exempted companies that permit the investor to redeem any portion of its ownership interest within two years after purchase, companies with total assets less than $1 million, and offshore funds not organized in the US that don't sell to US persons or are not organized, operated or sponsored by US persons. This is the proposal that was withdrawn in connection with FinCEN's decision to undertake a general review of BSA regulation. It is not clear when FinCEN's stated intention to improve this obligation might come to fruition.

***Persons Involved in Real Estate Closings and Settlements***

The BSA also names, but does not define, "persons involved in real estate closings and settlements" as financial institutions, and the legislative history does not provide any guidance as to Congress' intent. In 2003, FinCEN sought public comment relating to the establishment of anti-money-laundering program requirements for such entities, and in particular where money-laundering risks exist in real estate closings and settlements, how "persons involved in real estate closings and settlements" should be defined and whether they should be exempt.

FinCEN has determined that a reasonable interpretation of "persons involved in real estate closings and settlements" would include real estate brokers, attorneys who represent the seller or purchaser, a bank, mortgage broker or other financing entity, a title insurance company, an escrow agent, and real estate appraisers and inspectors. The bureau also has indicated that the definition may include institutional buyers and sellers of real estate, such as developers and investors. The standard to determine inclusion is that the requirements ought to apply to those who can effectively identify and guard against money laundering in real estate transactions and whose services can be abused by money launderers. FinCEN is particularly interested in participants and potential money-laundering risks in commercial real estate transactions.

**Pending Customer-Identification Obligations**
Section 326 of the Patriot Act requires Treasury to prescribe regulations for the establishment of customer-identification programs by financial institutions. At a minimum, the regulations must require financial institutions to implement reasonable policies and procedures to verify customer identity, maintain records of the information used for that purpose, and determine whether the identified customer appears on any government list of known or suspected terrorists or terrorist organizations. Section 326 also gives Treasury the authority to exempt any financial institution. As of publication, FinCEN has prescribed program requirements only for a limited number of banks and other financial institutions subject to federal functional regulation. Neither "persons involved in real estate closings and settlements" nor unregistered investment companies are included in that group and no proposed rulemakings have been issued. However, FinCEN has indicated its intent eventually to prescribe program requirements for non-bank financial institutions not subject to federal functional regulation, which may include "persons involved in real estate closings and settlements" and unregistered investment companies.

**Existing BSA Obligations**
While certain financial institutions, including "persons involved in real estate closings and settlements" and unregistered investment companies, are currently exempt from anti-money-laundering program requirements and have not been included in the requirements for currency-transaction reporting, suspicious-activity reporting and customer identification, foreign investors in US real estate still have certain obligations under the BSA. These include reporting of certain coin or currency receipts, information sharing, and general reporting with respect to money laundering or terrorist activity.

***Coin or Currency Reporting***
Financial institutions not subject to the BSA's general currency-transaction reporting requirements must comply with Section 365 of the Patriot Act, which requires trades or businesses that receive, in one transaction, or in two or more related transactions, more than $10,000 in domestic or foreign currency to file a report of the transaction(s) with FinCEN. Since a similar reporting requirement exists under the Internal Revenue Code, FinCEN requires subject financial institutions to file IRS Form 8300 jointly with FinCEN and the Internal Revenue Service providing the name, address and other identification information of the person providing the coin or currency, and the amount, date and nature of the transaction. The reporter must verify the identity of the person from whom the funds are received. The reporter also must retain copies of the report for five years. As foreign investors in US real estate are generally not subject to the BSA's general currency-transaction reporting requirements, compliance with Section 365 of the Patriot Act is required.

***Information Sharing***
Section 314(a) of the Patriot Act requires Treasury to adopt regulations to encourage information sharing between financial institutions and the government. By regulation, FinCEN requires all financial institutions to respond to government information requests "based on credible evidence concerning terrorist activity or money laundering." As potential financial institutions under the BSA, foreign investors in real estate would be subject to any such requests. Because no current obligation exists for foreign investors, however, it is unclear how likely such a request would be.

Section 314(b) of the Patriot Act provides for voluntary information sharing among financial institutions. FinCEN's regulation in this area has generally limited the definition of financial institution in this context to those required to establish anti-money-laundering programs. Until "persons involved in real estate closings and settlements" or unregistered investment companies are required to establish anti-money-laundering programs, it is unlikely foreign investors would be subject to Section 314's voluntary information sharing requirements.

### *General Reporting Obligation*

As part of its effort to prevent, detect and prosecute money laundering and the financing of terrorism, FinCEN has emphasized the general importance of all financial entities' reporting suspected terrorist activity or otherwise suspicious transactions.

## Office of Foreign Asset Control (OFAC)

While serving a similar purpose, the obligations under the regulations administered by the Office of Foreign Asset Control (OFAC) are separate and distinct from those under the BSA. OFAC is responsible for administering and enforcing laws that impose economic and trade sanctions against targeted foreign countries, organizations sponsoring terrorism and international narcotics traffickers. OFAC regulations are broadly applicable to all US persons and entities, including those operating in the US. This broad definition likely captures most foreign investors in US real estate.

Generally, OFAC regulations require US persons to block or freeze accounts and other assets of countries identified by the US president as being a threat to national security, to prohibit unlicensed trade and financial transactions with such companies, to block or reject accounts of and transactions with Specially Designated Nationals (SDNs) or other blocked persons, and to report blocked property and blocked or rejected transactions to OFAC. OFAC does not require that programs be in place to ensure compliance. The only compliance obligation is to detect and stop potentially suspect items. Many institutions use sophisticated software developed for this purpose. Once suspect items are detected, OFAC may assist in identifying the action to be taken (*i.e.*, process, block or reject). Violation of the laws implemented by the OFAC regulations occurs when a transaction is processed that should have been blocked or rejected. Violations may result in civil money and criminal penalties.

## "Best Practices" Recommendation

Considering the substantial risks associated with violating OFAC regulations, existing transaction-reporting and information-sharing requirements, and pending anti-money-laundering and customer-identification program requirements, many potential "persons involved in real estate closing and settlements" and currently exempt investment companies are establishing anti-money-laundering and customer-identification programs to better prepare for likely future requirements and to comply with the spirit of the law. It might be considered consistent with "best practices" for foreign investors in US real estate to implement a compliance program that touches upon all existing and potential BSA and OFAC obligations. Such a program should be commensurate with the size, location and activities of the foreign investor and its focus should be the statutory components of the anti-money-laundering and customer-identification programs. These components include:

- internal policies, procedures and controls
- a compliance officer
- an ongoing employee training program
- an independent audit function to test programs
- procedures to verify the identification of customers
- maintenance of records used to verify identity
- a screen against SDNs and other designated terrorists and terrorist organizations.

These components should adequately address investors' obligations under OFAC regulations and the verification procedures required with respect to coin and currency reporting.

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# Chapter 20

## VISAS AND OTHER ENTRY REQUIREMENTS

Robert E. Banta, Banta Immigration Law Limited

Immigration laws offer foreign investors in real estate several options for entering the US, from short visits to permanent residence.

Canadian citizens and citizens of most other industrialized countries can enter for up to 90 days without a visa to conduct "business." (Citizens of all other countries coming to conduct "business" must first obtain a B–1 business visitor visa from a US consulate.) Appropriate "business" activities include visiting potential investments, conducting negotiations and meeting with US managers about operations. Business visitors are prohibited from "working" (providing services in exchange for remuneration or actively participating in business operations) in the US, however. The difficulty in distinguishing between appropriate "business" activities and prohibited "work" often makes obtaining a temporary work visa advisable for a foreign investor traveling frequently to the US, especially when that travel occurs in conjunction with active real estate operations.

Temporary work visas allow stays in the US of several years. The applicant must usually show that he or she is involved with active real estate operations in the US, as opposed to passive holdings, in order to be eligible for a temporary work visa. The temporary visas most frequently used by foreign investors in active US real estate operations are the E–2 treaty investor visa and the L–1 intra-company transferee visa.

E–2 visas are granted to citizens of countries that have a treaty with the US. A citizen of a qualifying country may obtain an E–2 visa by making a "substantial" investment in an active US enterprise that the investor will develop and direct. The law does not stipulate any minimum amount of capital necessary to qualify an investment as "substantial," offering instead a "sliding-scale" approach that compares an investment's overall value and the amount of capital invested. Typically, at least $100,000 is required for E–2 visa eligibility. Approximately 75 countries have treaties qualifying their citizens for E–2 visas. The E–2 visa typically can be renewed indefinitely as long as the investor remains actively engaged in managing a qualifying investment.

A foreign company that has a related entity in the US developing US real estate or operating some type of business may transfer qualifying personnel using an L-1 intra-company transferee visa. Executives, managers and employees with "specialized knowledge" may qualify as long as they have worked for the foreign employer for at least one year. L-1 executives and managers may remain in the US for up to seven years, while personnel with specialized knowledge are limited to five years.

Foreign investors wishing to live permanently in the US may qualify for a green card. Investors who are managers or executives and who have transferred from overseas to work in affiliated US companies may qualify for green cards without being subject to any minimum investment requirement or labor-market test showing a need for their skills. Foreign investors who have invested large amounts of capital (generally, at least $1 million, sometimes less in certain rural or high unemployment areas) in a business that has created at least 10 employment positions for US workers may also qualify for green cards. Investors in US real estate projects that are part of an approved "Regional Center" may be excused from the employment-creation requirement.

**Robert E. Banta, Managing Partner, Banta Immigration Law Limited**

Robert Banta is the managing partner of Banta Immigration Law Limited, Atlanta's largest law firm practicing exclusively business immigration law. He received his BA from Davidson College, his MA in romance languages (French) from Duke University, and his JD from Vanderbilt University. He is recognized for his immigration expertise in *The Best Lawyers in America*, *The International Who's Who of Business Lawyers*, *Atlanta* magazine's list of "The Best Lawyers in Atlanta" and *Georgia Super Lawyers*.

# Chapter 21

## PARTNERSHIP WITHHOLDING OBLIGATIONS ON EFFECTIVELY CONNECTED INCOME

Patrick Williams and Arthur Marlow, World Tax Partners LLP and Bennett Thrasher PC

In response to concern that foreign partners were not complying with US tax laws, Congress added Section 1446 to the Internal Revenue Code in 1986[1] to require partnerships to withhold US tax on foreign partners' US income that is "effectively connected" to a US business or trade operation. This "effectively connected income" (ECI) includes income from US real property.[2] Specifically, Section 1446 requires any partnership that has US effectively connected taxable income (ECTI) to withhold, pay and report US withholding tax on the ECTI allocable to foreign partners at a rate equal to the highest US individual income tax rate (currently 35 percent). A partnership may be liable for penalties and interest if it does not pay quarterly installments of Section 1446 withholdings.

The five sections of the regulations set out how a partnership must:

- determine if it has foreign partners
- determine if it has any ECTI allocable to foreign partners
- compute the tax
- pay the tax
- report the amount paid.

The regulations also provide rules for dealing with publicly traded partnerships and trusts (neither of which will be discussed here), rules for tiered partnership structures and rules designed to ease over-withholding.

### Determining Foreign Partners

Generally, a partnership must assume that a partner is a foreign person unless the partner certifies that it is not. A partnership generally can identify a US partner by obtaining a properly completed Form W-9, and can identify a foreign

1 As subsequently amended in 1988 and 1989.

2 Which is either ECI based on facts and circumstances or deemed to be ECI based on a partner's election under Sections 871(d) or 882(d), *i.e.*, a "Net-Basis" election.

partner by obtaining a valid Form W-8 series certification of foreign status[3] or an acceptable substitute form. A certificate on a W-8 series form is generally valid for a period of three years (unless there has been a change in the partner's circumstances) if it contains the partner's name, permanent address and taxpayer identification number, the country under the laws of which the partner was formed (if the partner is not an individual), the classification of the partner for US tax purposes, and any other information that may be required by the form or instructions.

The partnership may rely on a partner's certification but will be liable for failure to withhold tax (and to related penalties) if the partnership has actual knowledge or reason to know that information on the certificate is incorrect or unreliable. If the partnership has knowledge or reason to know that the information on the certificate is incorrect or unreliable, the partnership must presume the partner is either a foreign individual or a foreign corporation, whichever presumption results in the higher tax. As discussed below, it is very important to have a complete and valid certificate to take advantage of the opportunities provided by the regulations.

### Determining ECTI Allocable to Foreign Partners

The share of partnership ECTI that is allocable (under Section 704) to a particular foreign partner generally is equal to its distributive share of effectively connected partnership gross income and gain reduced by the foreign partner's distributive share of partnership deductions, except charitable contributions and excess capital losses, allocable to such gross income and gain. Except as provided in special rules discussed below, in computing partnership ECTI, the partnership may not take into account any otherwise-deductible expenses determined at the partner level (such as the personal exemption, itemized deductions, net operating losses, passive losses, *etc.*). These partner-level items can still be claimed by the foreign partner when computing its tax liability and filing its US income tax return, however.

Whether a partnership's US rental real estate constitutes a US trade or business and whether its income therefore constitutes ECI depends on the facts and circumstances of each case.[4] In the absence of a definitive conclusion based on the facts and circumstances, most foreign partners elect, under Sections 871(d) or 882(d), to treat income that is otherwise not effectively connected with a US trade or business as if it were. This election generally enables non-resident aliens and foreign corporations to avoid withholding by the partnership under Section 1441, and to claim trade or business deductions (including depreciation) against rental income, thereby reducing the tax base and the tax rate on it. Income subject to this election will be subject to withholding by the partnership under Section 1446, however. The regulations specifically require a partner that makes a Section 871(d) or 882(d) election to furnish to the partnership a "Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade or Business in the United States" (Form W-8ECI).

### Computing the Tax

The Section 1446 tax equals the foreign partner's ECTI multiplied by the "applicable percentage," which is generally the highest rate of US income tax.

[3] For a non-resident alien, foreign estate, foreign corporation or foreign government, Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding." For a foreign partnership, Form W-8IMY, "Certificate of Foreign Intermediary, Flow-Through Entity, or Certain US Branches for United States Tax Withholding." For a US person, Form W-9, "Request for Taxpayer Identification Number and Certification."

[4] See Section 875.

If a foreign partner is eligible for a preferential tax rate, however, then the partnership is permitted to consider as the "applicable percentage" the highest specified preferential tax rate applicable to the income or gain allocable to the foreign partner. As a result, when withholding on a foreign individual partner a partnership can generally use the highest capital-gains rate for long-term capital gains or the maximum rate for unrecaptured Section 1250 gain.[5] The partnership is not permitted to use these preferential rates if their use depends on the corporate or non-corporate status of the foreign partner and the foreign partner has not properly certified its status. For this purpose, the presumption of foreign status is disregarded, so to take advantage of this provision the partnership must receive from the foreign partner valid Form W-8 series certification of foreign status or an acceptable substitute. Accordingly, to obtain reduced withholding on its allocable share of a partnership's capital gain income, a foreign individual partner must timely certify its status on a valid Form W-8BEN. Absent such documentation, the partnership must withhold at the maximum tax rate.

The regulations require a partnership to withhold under Section 1446 even when Section 1445, the "Foreign Investment in Real Property Tax Act" or FIRPTA, also technically applies. This "trumping rule" imposes a primary obligation to withhold under Section 1446, but a foreign partnership is permitted to credit the FIRPTA withholding against its Section 1446 tax obligation.

## Paying the Tax

Generally, a partnership must pay the Section 1446 tax by making estimated installment payments on or before the 15th day of the fourth, sixth, ninth and twelfth months of its taxable year. Any additional Section 1446 tax must be paid with the filing of the annual return (Form 8804) on or before the 15th day of the fourth month of the following taxable year (or the 15th day of the sixth month of the following taxable year in the case of a foreign partnership that keeps its books and records outside the US).

The estimated payments are generally made using either the "safe harbor" method or one of the available annualization methods. The "safe harbor" method is available if the average current-year installment is at least 25 percent of the prior year's Section 1446 tax, the prior year consisted of 12 months, the partnership timely files the prior-year return, and the ECTI on the current-year return is not greater than twice the prior-year ECTI. A number of annualization methods allow a partnership to determine its current year installments based on estimates of the partnership's actual income for the year.

The regulations entitle a partnership to receive a refund of any excess installment payments not credited to foreign partners.

A partnership that fails to properly make estimated installment payments will be subject to additions to tax, and failure to comply with other requirements of Section 1446 may lead to interest charges, penalties and other additions to tax.

## Reporting the Tax Paid

### Reporting Installment Payments

Each partnership required to make an installment payment of Section 1446 tax is required to notify its foreign partners of payment made on the partner's behalf within 10 days of the installment due date or, if paid later, the date such installment payment is made. No particular form is required for a partnership's notification to a foreign partner, but each notification must include the partnership's name, address and taxpayer identification number; the partner's name, address and taxpayer identification number; the

[5] Note that current US tax law does not provide preferential tax rates for foreign corporate partners.

annualized ECTI estimated to be allocable to the foreign partner; and the amount of tax paid on behalf of the partner for the current period and any prior periods.

A partnership is not required to provide such a notification unless requested by the partner, if the partnership's agent responsible for providing the notice is the same person that acts as agent of the foreign partner for purposes of filing the partner's US tax return, or if the partnership has at least 500 foreign partners and the total Section 1446 tax withheld for the taxable year to be on such partner's behalf is less than $1,000.

**Annual Return and Notification**

Every partnership that has ECTI allocable to a foreign partner must annually file Form 8804 "Annual Return for Partnership Withholding Tax (Section 1446)." Additionally, every partnership required to file Form 8804 must also annually file Form 8805 "Foreign Partner's Information Statement of Section 1446 Withholding Tax," for each of its foreign partners on whose behalf it paid Section 1446 tax.

**Crediting Section 1446 Tax Against a Foreign Partner's US Tax**

A partner may claim as a credit the Section 1446 tax paid by the partnership with respect to ECTI allocable to that partner. The partner may not claim an early refund of these amounts. Generally, the Section 1446 tax withheld will be allowed as a credit only if Form 8805 is attached to the foreign partner's return to substantiate the credit, and the name and taxpayer identification number on the Form 8805 match the name and taxpayer identification number on the foreign partner's US tax return.

**Effect of Withholding on the Foreign Partner**

The payment of Section 1446 tax by the partnership does not excuse a foreign partner from filing a US tax return.

### TIERED PARTNERSHIP STRUCTURE

The regulations permit a lower-tier partnership (LTP) receiving documentation from a partner that is a foreign partnership (an upper-tier partnership or UTP) to look through the UTP to the UTP's partners when computing its own Section 1446 tax obligation. The look-through rule is used to determine whether a foreign UTP itself has foreign partners, the type of foreign partner, and whether any income or gain is potentially subject to a preferential rate, all factors that may reduce the amount of Section 1446 tax.

A domestic UTP that is a partner in a LTP may elect to apply the look-through rules to have the LTP compute the Section 1446 tax liability if the LTP consents in writing. Such consent may be revoked or modified, in writing, at any time.

### RULES TO EASE OVER-WITHHOLDING

To ease over-withholding, new rules in the regulations describe when a partnership may consider certain partner-level deductions and losses in computing its Section 1446 tax obligation and provides for consideration of certain other circumstances with respect to a non-resident alien partner. A partnership determines the applicability of these new rules separately for each partner and each installment, and when completing the annual Form 8804.

The rules apply to a qualifying foreign partner that has provided complete and valid documentation as to its status,[6] has timely filed or will timely file a US tax return in each of the preceding three taxable years and for the current year, and has timely paid or will timely pay all tax shown on such returns.

[6] *e.g.*, Form W-8BEN or acceptable substitute form.

They also apply to a properly documented UTP, but not to a foreign estate or to certain foreign trusts.

A foreign partner qualifying for these new rules may certify annually that it has deductions and losses that it reasonably expects to be available to reduce its US income-tax liability. Such deductions and losses must be properly reflected on a timely-filed prior-year US income tax return. They may be items reflected on the partnership's prior-year Schedule K–1, another partnership's prior-year Schedule K–1, or other deductions and losses of the foreign partner as long as they are connected with gross income effectively connected with the foreign partner's US trade or business. A partnership may not take into account a foreign partner's certification of a net operating loss or of state and local taxes in an amount greater than 90 percent of the foreign partner's allocable share of ECTI. The partnership must receive the foreign individual partner's certificate before an installment due date or before the filing of Form 8804. If at any time the foreign partner expects to have deductions and losses less than the amount certified, it must notify the partnership so that proper adjustments can be made in computing subsequent installment payments.

Subject to these requirements, a foreign individual partner may certify to a partnership that its only activity giving rise to ECI is (and will be) its investment in the partnership. The foreign individual partner certificate must be submitted to the partnership each year. A partnership that receives such a certificate from a foreign individual partner is not required to pay Section 1446 tax (or any installment of such tax) if it estimates that the annualized (or actual) Section 1446 tax due with respect to the foreign individual partner is less than $1,000. This certification cannot be combined with a foreign individual partner's certification of deductions and losses mentioned above, and the partnership must receive it prior to an installment due date or the filing of Form 8804.

A partnership that reasonably relies on a foreign partner's certification will generally remain liable for under-withholding of Section 1446 tax but may be excused from liability for additions to tax arising from failure to pay the required amount of quarterly installments.

A partnership that relies in whole or in part on a foreign partner's certificate must file Form 8813 "Partnership Withholding Tax Payment Voucher (Section 1446)" or Forms 8804 "Annual Return for Partnership Withholding Tax (Section 1446)" and 8805 "Foreign Partner's Information Statement of Section 1446 Withholding Tax," whichever is applicable, for the period for which the certificate is considered, even if no Section 1446 tax (or installment of such tax) is due with respect to the foreign partner. The partnership must also attach a copy of the certificate and the partnership's computation of Section 1446 tax due with respect to the foreign partner, to both the Forms 8813 and 8805 for the first period such certificate is considered in computing the partnership's Section 1446 tax (or any installment of it).

Prior to July 2008, the regulations did not require a particular form for certification of either the deductions and losses or the foreign individual partner. Since July 28, 2008, however, foreign partners must submit all certificates using Form 8804–C "Certificate of Partner-Level Items to Reduce Section 1446 Withholding."

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# Chapter 22

## GENERAL US INCOME TAX RULES AFFECTING FOREIGN EQUITY AND DEBT INVESTMENT IN REAL ESTATE

Patrick Williams, World Tax Partners LLP and Bennett Thrasher PC,
with the assistance of Timothy M. Kelly and William E. Albaugh

The US is unusual among nations in taxing both its citizens and corporations on their worldwide income regardless of their residence. Foreign persons, *e.g.*, nonresidents and foreign corporations, which conduct economic activities within the US, are generally subject to two US taxation regimes.

Under the first regime, a foreign person is subject to US tax on net income which is "effectively connected" with the conduct of a trade or business within the US (effectively connected income or ECI). If a foreign person is a resident of a country with an income tax treaty with the US, however, the foreign person generally is subject to US tax on net income "attributable to a permanent establishment" within the US. The concept of profits attributable to a US permanent establishment is somewhat narrower than the concept of taxing ECI.

Under the second regime, a foreign person is subject to a 30 percent withholding tax on US-sourced, fixed and determinable annual or periodical (FDAP) income not effectively connected with the conduct of a US trade or business. In broad terms, FDAP income includes interest, dividends, rents, royalties and other types of income, except for that from the sale or exchange of capital assets. In some cases, the 30 percent withholding tax may be reduced by treaty.

### Effectively Connected Income

Whether income of a foreign person is taxable as effectively connected with a trade or business requires analysis of whether the foreign person is engaged in the conduct of a US trade or business and, if so, to what extent the income of the foreign person is effectively connected with the conduct of the US trade or business.

US tax laws do not define "trade or business," but case law and administrative rulings based on facts and circumstances have determined if a foreign person is regularly, continuously and substantially engaged in a trade or business within the US. The activities may be performed directly by the foreign corporation or through agents.

Generally, a trade or business enterprise must be "active." In other words, the foreign person must be regularly and continuously engaged in the underlying activity rather than merely serving as a passive investor. In addition, the activity must involve the exercise of discretion or business judgment necessary for the production of income, as opposed to simply ministerial and clerical tasks. Activities which advance the purposes for which the foreign corporation was formed will generally meet this standard, and the performance of personal services in the US at any time within a taxable year generally constitutes a US trade or business.

**Real Estate Activities Constituting US Trade or Business**

Facts and circumstances also determine whether the US real estate activities of a foreign person constitute a US trade or business. Mere ownership of real property or the receipt of income therefrom does not, so ownership of a single piece of US real estate leased to tenants on a triple-net basis generally does not constitute engaging in a US trade or business. However, ownership of several US real properties with substantial, regular and continuous management activity of a foreign person (whether performed directly or indirectly through an agent) generally does.

A foreign person investing in a US real estate venture that does not constitute a US trade or business must pay a 30 percent tax (without allowance for any deductions) on certain FDAP income (gross rents) derived from US real estate. When the income results from real estate activities that constitute a US trade or business, however, all of the foreign investor's income that is effectively connected with the investor's US trade or business is subject to graduated tax rates. Further, these rates are applied to the US-source income after all allocable deductions, including depreciation.

Foreign persons are permitted to make a "net-basis election" to treat income not otherwise effectively connected from the real estate activity on a net basis, as if it were effectively connected. The election enables foreign persons to claim trade or business deductions, including depreciation, against rental income, thereby reducing the tax base and generally the effective tax rate on the enterprise.

Foreign persons investing in US real estate through US or foreign partnerships, estates or trusts which have ECI are themselves deemed to be engaged in a US trade or business. However, a foreign person's ownership of stock in a US corporation engaged in a US real estate trade or business generally does not constitute a US trade or business. (REITs are discussed elsewhere in this volume. See Chapter 25: Foreign Investment in REITs.)

**Choice of Entity**

Due in part to the difficulty and cost of making changes, one of the most important decisions for a foreign person undertaking a US real estate activity is the form and type of entity in which to operate.

The more common forms of US business operation are:

- corporation
- partnership
- special entity, such as a REIT (see Chapter 25)
- branch.

It is relatively uncommon for foreign enterprises to operate as a branch without careful planning. From a tax perspective, the income of a branch (like that of a US corporation) is initially taxed whether or not distributed (see discussion below). However, use of a branch structure may complicate tax planning for the foreign corporation in its home jurisdiction or elsewhere due to the inherent inflexibility of the branch form.

Since the mid-1990s, limited liability companies (LLCs) have become increasingly popular vehicles for holding US real estate. In general, LLCs are treated as transparent (in the case of a single owner) or as partnerships (where there are multiple owners). Under some circumstances, an LLC or a legal partnership can opt to be taxed as a US corporation. Often, individual real property holdings are owned through single-member LLCs, in turn owned under a corporate entity or a master LLC; so that at disposition the LLC holding the property is sold rather than transferring or selling the specific property (for example, when many individual leases or contracts on the property would have to be reworked in a sale). Such use of LLCs may mitigate certain practical issues encountered when properties are transferred.

### Federal and State Taxes on ECI

The US federal and state tax rate structures are progressive, meaning that the rate of tax varies with the amount of income being taxed. Just as US resident individuals and US corporations face different tax rates, federal tax rates differ for foreign individuals and foreign corporations. State tax rates vary, and in general are different for foreign individuals than for foreign corporations.

### Foreign Individuals

Foreign individuals are generally subject to US federal tax on ECI after subtracting a personal exemption ($3,500 in 2008). The 2008 progressive tax rates on the resulting income begin at 10 percent on income up to $8,025. They reach 35 percent on income of $357,700 for unmarried foreign individuals and $178,850 for married foreign individuals.

Unlike foreign corporations, foreign individuals are permitted to apply US capital-gains tax rates to any amount of ECI that is eligible. The 2008 US capital-gains tax rate for individuals is generally 15 percent but it is 0 percent for individuals, including foreign individuals, with income up to $32,550. A special US capital-gains tax rate of up to 25 percent applies to any portion of a capital gain attributable to a claw-back of prior depreciation expense. In addition, a special and complicated rule (the alternative minimum tax) applies to foreign individuals if a capital gain is attributable to US real property. The capital-gains tax rates are scheduled to change in 2011.

State taxes are generally imposed on the portion of ECI attributable to a particular state. These rates vary from 0 percent (Florida and Texas) to around 9 percent (California and New Jersey). Income taxes levied by cities are relatively rare, with some important exceptions like New York City.

### Foreign Corporations

Foreign corporations are generally subject to US tax on ECI using progressive rates that begin (for 2008) at 15 percent on the first $50,000 and rise to 35 percent on income in excess of $18,333,333. State taxes are generally imposed on the portion of ECI generated from a particular state, with attribution commonly achieved either through direct allocation or under a formulary-apportionment calculation. The state tax rates vary from 0 percent (Nevada) to around 9 percent (California and New York).

Foreign corporations are also subject to the branch profits tax and the branch interest tax. The theory underlying these is to align US tax rate for a foreign corporation conducting its business through a US subsidiary and one doing business through the foreign corporation itself (that is, through a branch).

If a foreign corporation owns a US subsidiary corporation, the US corporation is subject to US corporate tax on its worldwide income. In addition, a 30 percent withholding (lower in some cases by treaty) tax applies on any dividends paid by the domestic corporation to its foreign corporate shareholder. Thus, a foreign corporation that conducts its US trade or business through a domestic corporation bears two levels of US income tax on the distributed earnings from its US business: the profits are first taxed when generated inside the entity, and again when they are distributed.

*Branch Profits Tax*

The branch profits tax imposed at a 30 percent rate (or a lower treaty rate, if applicable) acts as a substitute for the withholding tax on dividends paid by a domestic corporation to its foreign shareholder(s). The branch profits tax is imposed (after subtracting any corporate income tax liability) on a foreign corporation's earnings from its US trades or businesses that are not reinvested in US trades or business by the close of the taxable year, or on earnings that are disinvested from a US trade or business in a later taxable year. US tax law refers to the base to which the branch profits tax is applied as the "dividend equivalent amount." For purposes of calculating the branch profits tax, the measure of whether the foreign corporation's earnings from the US trades or business have been reinvested in or withdrawn from the US trades or businesses is measured by the net change in the amount of the foreign corporation's equity (assets over liabilities) in the US trades or businesses. An increase in the equity during the taxable year generally is treated as a reinvestment for that year; a decrease in the equity generally is treated as a disinvestment of prior years' earnings that have not been subject to the branch profits tax. The concept underlying this calculation is that the branch profits tax should apply to a base that is equivalent to the amount that the US branch could have distributed to the foreign corporation if it had been operated as a domestic subsidiary of the foreign corporation.

*Branch Interest Tax*

Similar in intent to the branch profits tax, the branch interest tax seeks to align the treatment of interest paid or accrued by US branches of foreign corporations with the treatment of interest paid or accrued by US subsidiaries of foreign corporations. With certain exceptions, interest paid by a domestic corporation to a foreign person is subject to a 30 percent withholding tax. Under the branch interest tax, interest paid by a foreign corporation allocable to US ECI is treated as though paid by a US corporation and thus is generally subject to the 30 percent withholding tax (or to an alternate treaty-reduced tax rate).

The branch interest tax is imposed as corporate-level tax on the excess of interest deductible by a foreign corporation over interest treated as paid by US businesses operated by the foreign corporation. If the foreign corporation's interest allowable as a tax deduction in computing its effectively connected income exceeds certain interest paid by its US trades or businesses, the excess is treated as interest paid to the foreign corporation by a wholly-owned domestic subsidiary and hence subject to the withholding tax. The branch-level interest tax is an analogous to the withholding tax on interest paid by US corporations to foreign persons.

**Alternative Minimum Tax**

The alternative minimum tax (AMT) is a mandatory parallel tax calculation which generally attempts to minimize the benefit of certain excessive targeted tax deductions. After the traditional calculation of "taxable income" as income less allowable expenses and applying the graduated tax rate, the taxpayer computes the alternative minimum tax by using the same taxable income, eliminating certain deductions, adding back certain tax "preferences" and making other technical adjustments. A flat tax rate and exemption amount are applied and the taxpayer pays the higher of the tax amounts resulting from the two calculations. The AMT applies to both individuals (which is especially complicated if there is a sale of US real property) and corporations. This calculation and result can be frustrating, and has been subject to annual "updates" and changes by Congress in recent years. Every entity should include the AMT in any tax planning, especially in loss situations and in disposition planning.

**Depreciation**

Depreciation is typically the largest tax deduction in real estate operations. US tax law allows a deduction for a portion of the cost or basis of capitalized assets used during the tax year in a trade or business, or held for the production of income. Depreciation is relatively simple in concept, but the very large number of changes in tax law during the past several years requires attention to detail. Generally, real estate assets are depreciated over 39 years, although there are important exceptions: the depreciable life of residential rental property is generally 27.5 years. Special rules also provide shorter tax lives for restaurants, leasehold improvements and land improvements such as roads, sidewalks and landscaping. These rules change regularly, and require frequent review of the published tables to ensure appropriate deductions each year.

**Net Operating Losses**

Normally net operating losses (NOLs) can be used as an offset against taxable income in two prior years. If not exhausted in prior years, the remaining NOL can be carried forward 20 years. The taxpayer can elect to forgo a carryback (for example, if the tax rate in those prior years was relatively low compared to forecast rates). Special rules apply to small and special businesses.

**Passive-Activity Limitations**

Three sets of rules apply to a taxpayer or investor's right to deduct a distributive share of a taxable loss in certain investments:

- basis limitations (IRC Sections 704 & 752)
- "at-risk" limitations (IRC Section 465)
- passive-activity limitations (IRC Section 469).

The basis and at-risk limitations are quantitative tests of whether the taxpayer/investor has sufficient investment in the enterprise. The passive-activity rules measure the extent of taxpayer/investor activity.

A passive activity is any activity involving the trade or business in which the taxpayer does not "materially participate" (*i.e.*, participate on a regular, continuous and substantial basis). These rules apply to individuals, estates and trusts, personal service corporations and certain closely-held corporations. Rental real estate is presumed to be a passive activity, even if the taxpayer manages the property. The only exception is for real estate professionals or "active participants" in rental real estate who have adjusted gross income of $100,000 or less and net passive loss of $25,000 or less. By statute, limited partnerships are presumed to be activities in which the limited partners do not materially or actively participate.

In general, unless the taxpayer is "active" (determined by the number of hour's involvement and other facts and circumstances), these rules defer investment losses until passive-activity gains are generated (see below), or until the property is sold or relinquished. Accordingly, there are important implications to how activities and investments are grouped. The rules are complex and require detailed investigation of the property, owners and their activity and involvement.

**Like-Kind Exchanges**

US tax law allows a taxpayer to defer the gain or loss on an exchange of like-kind property; the tax basis of the newly acquired property is determined by the substituted tax basis of the property given up, plus or minus adjustments for cash or liabilities assumed. Partnership or LLC interests are not eligible for like-kind treatment; only the underlying property inside the entity is eligible for this deferral opportunity. When US property is to be sold, and if the proceeds are to be reinvested into US property of a like kind, a tax-deferred exchange can allow the investment on a pre-tax basis. This technique is highly valuable in the right circumstances. Very detailed rules apply, state tax laws may add additional requirements for deferral.

**Debt *versus* Equity and Earnings-Stripping Limitations**

One of the key advantages to debt financing is that the payor can deduct interest expense. Since a dividend payment is not deductible, many companies try to marginally capitalize an entity and "strip" earnings out through interest payments. To prevent this, US case law has developed various "thin capitalization" concepts and Congress has enacted "earnings-stripping" provisions. Under the thin-capitalization rules, purported debt may be reclassified as equity for US tax purposes. Thin-capitalization challenges by the IRS focus on certain factors that suggest whether a loan reflects an arm's-length relationship between borrower and lender. Among the factors normally considered are whether there is:

- adequate capitalization of the debtor
- adequate projected cash flow to service the purported debt
- a fixed maturity date
- subordination of the purported debt
- managerial rights to the lender
- symmetrical equity participation by the lender
- consistent characterization and treatment of the arrangement by the parties as debt.

This analysis looks to establish whether an unrelated lender would have made a loan under similar terms and conditions. Under the earnings-stripping rules, a corporation's ability to deduct interest paid to certain foreign payees, including interest on certain loans made or guaranteed by a foreign related person, may be limited and deferred. While the mechanics of the rules are complex, the rules do not apply where the taxpayer has significant earnings from operations to justify the debt, or the corporation has a debt-to-equity ratio of 1.5 to 1 or less. Generally, any interest expense may be deferred until a future tax year where the corporation pays interest in excess of 50 percent of its adjusted taxable income. (Adjusted taxable income ignores certain non-cash deductions including depreciation, amortization, depletion, net interest expense, net operating losses and gains to the extent of previous depreciation deductions.) Any disallowed interest expense may be carried forward indefinitely and deducted in a year where the taxpayer has adjusted taxable income to absorb the additional interest expense.

**Other Limitations to Interest Deduction**

Under complex IRS regulations, a foreign corporation operating with a US branch may deduct interest expense only in an amount allocable to its US activity. While simple in concept, in practice this limitation is extremely difficult to apply and may result in counterintuitive and unanticipated consequences. Any planned operation in branch form should carefully consider the potential impact of these provisions.

**Foreign Investment in Real Property Tax Act**

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) applies US tax to a foreign person's disposition of US real property interests. Specifically, FIRPTA treats any gain from dispositions of US real property interests as ECI and taxes the transaction accordingly. To ensure that the US is able to collect the tax on such gains, FIRPTA also requires withholding on such dispositions. For this purpose, shares in a US corporation, over half the assets of which consist of US real property interests, are also considered US real property interests. A number of states (California and Hawaii, for example) have versions of FIRPTA for dispositions of property within their state. (For a discussion of FIRPTA, please see Chapter 24: Taxation of Foreign Investors in US Real Estate Under FIRPTA.)

## FDAP Income (Fixed, Determinable, Annual or Periodical)

US tax law imposes a flat 30 percent tax on certain types of US-source income realized by a foreign person if the income is not effectively connected with the conduct of a US trade or business. This tax is withheld by the payor at the time of payment.

### Income-Tax Treaties

The US has income-tax treaties in force with 40 countries, generally for the purpose of facilitating international trade and investment by removing tax barriers. A simple method of removing tax barriers is to have a treaty that reduces the rate of tax on income. Most US income-tax treaties provide for the reduction of withholding tax rates on types of FDAP income. The IRS has stated that US tax treaties have three main functions:

- preventing the double taxation of income
- preventing discriminatory tax treatment of a resident of a treaty country
- permitting reciprocal administration to prevent tax avoidance and evasion.

### Bank Deposits

Interest earned by a foreign person on US bank deposits is not subject to the 30 percent tax on FDAP income even though the income is from a US source. However, deposit interest that is effectively connected with a US trade or business is subject to US tax as ECI.

### Portfolio Debt Exception

US-source interest received by a foreign person is not subject to 30 percent tax if it is "portfolio interest," meaning any interest paid on an obligation in either bearer or registered form. A bearer obligation is any obligation not in registered form with arrangements reasonably designed to ensure that it will be sold or resold only to non-US persons, on which interest is payable only outside the US and the face of which states that any US person holding it will be subject to limitations under US tax law. A registered obligation is one with respect to which the US person — otherwise required to withhold tax from interest paid on the obligation — has received a statement that the beneficial owner is not a US person. An obligation is in registered form if it is registered as to both principal and stated interest with the issuer or its agent, and its transfer may be effected only through surrender and re-issuance or replacement by the issuer to the new holder. Transfer may also be effected through a book entry system maintained by the issuer or its agent. An obligation that at any time in the future may be converted into one not in registered form is not a registered obligation. Once the possibility of conversion to bearer form terminates, an obligation is treated as registered.

Interest otherwise constituting portfolio interest will be subject to 30 percent tax if such interest is contingent or if paid to a 10 percent shareholder. For this purpose, a 10 percent shareholder is any person who owns, directly or indirectly, 10 percent or more of the combined voting power of all classes of stock, or 10 percent or more of a capital or profits interest in a partnership. Interest is generally contingent if it is determined by reference to any receipts, income or change in value of property of the debtor or a related person. The IRS may determine other types of interest to be contingent if necessary or appropriate to prevent tax avoidance.

### Conduit Arrangements

In an attempt to avoid the related-party exception to the portfolio-interest exemption, two related parties may interpose an unrelated intermediate party. The IRS, however, has authority to disregard the participation of intermediate entities in a financing arrangement as "conduit entities" if, among other requirements, a purpose of the arrangement was to avoid federal withholding tax.

The IRS will consider an intermediary to be a conduit entity if it meets three requirements:

- the participation of the intermediate entity reduces the withholding tax
- the participation of the intermediate entity is pursuant to a tax-avoidance plan
- the intermediate entity is related to either the financing or the financed entity or it is unrelated to either but "would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity."

When it finds that a conduit entity was used, the IRS has the authority to recharacterize the payments and treat them as if they had been made directly to the foreign-related person.

## Compliance Matters

### Partnership Withholding

US tax law requires a partnership to withhold tax on a foreign partner's allocable share of effectively connected taxable income from the partnership. (For a discussion of these rules, please see Chapter 21: Partnership Witholding Obligations on Effectively Connected Income.)

### Tax Compliance and Penalties

The US requires an increasing amount of information to be filed annually, and the penalties for failure to file have increased dramatically. Careful review and precision are essential as the stakes rise with the IRS' increased interest in transparency and disclosure.

For a US corporation owned by foreign entities, an important annual filing is Form 5472, "Information Return of a 25 percent Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business." Even though it is only an information return, the penalty for failure to meet the filing requirement is $10,000 for each form. Tax need not be due for the penalty to apply. Since January 1, 2009, the IRS has announced it will automatically assess this penalty for late-filed forms. Taxpayers can ask for reasonable-cause relief, with requests to be considered on a case-by-case basis in light of facts and circumstances.

Other important forms may be required, including:

- SS-4, Application for Employer Identification Number
- W-8 Series forms, certificate of certain foreign status — to claim certain reductions or zero withholding on US-source income received by a foreign corporation
- Form 1042 Series, annual withholding tax returns for US-source income of foreign persons
- Form 5713, International Boycott Report
- Form 8275, Disclosure Statement
- Form Series 8804, 8805 and 8813, for reporting the Section 1446 withholding tax based on US effectively connected income allocable to foreign partners
- Form 8832, Entity Classification Election
- Form 8833, Treaty Based Return Positions
- Form 8883, Asset Allocation Statement under Section 338
- Form TD F 990–22.1, Report of Foreign Bank and Financial Accounts.

Each of these has unique requirements and penalties for failure to comply.

The IRS has elevated withholding taxes to a high priority. As such, withholding will receive much greater scrutiny from IRS examiners, and will be a mandatory part of certain income tax audits.

In July 2008, the IRS issued guidance to its examiners increasing focus on withholding and related compliance reporting for FDAP-type payments to foreign persons. The guidance is intended to cover two types of US withholding-agent audits: those of US financial institutions which may have non-resident alien withholding tax and reporting requirements in connection with their custodial or brokerage activities, and those of US non-financial entities that may have US tax withholding and reporting responsibilities with respect to their payments to foreign persons for obtaining services or other entitlements.

**Transfer Pricing**

Intercompany activities, especially when crossing international borders, are also under increasing scrutiny because of the volume of activity and the possibility for error or abuse. US taxpayers have flexibility to arrange their own affairs, but must be mindful of the US prescriptions on cross-border transactions. These transactions can include loans and advances, services, use of intangibles, cost-sharing agreements and intercompany sales of tangible personal property. Generally, taxpayers are required to employ the method, among the following options, that produces the most accurate result:

- the comparable uncontrolled-price method
- the resale-price method
- the cost-plus method
- the comparable-profits method
- the profit-split method
- other methods indicated for specific cases.

Taxpayers should have in place contemporaneous documentation for the pricing method chosen at the time of the filing of the income-tax returns.

**Disclosure and Use of Taxpayer Information**

US tax law has confidentiality rules designed to protect taxpayers from disclosure of information furnished to tax return preparers. Enhanced civil and criminal penalties apply to preparers if they disclose or use information inappropriately. New requirements also require security controls whenever individual tax-return information is sent across borders.

**Other Considerations**

Financial statement audits are not required for income-tax compliance, although they are commonly required to meet loan covenants, and often by corporate or joint-venture owners.

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# Chapter 23

## HOME-COUNTRY TAX CONSIDERATIONS FOR FOREIGN REIT INVESTORS

Mark van Casteren, Loyens & Loeff, with contributions from Jones Day, Paris, and Pollath & Partners, Frankfurt

Chapter 25: Foreign Investment in REITs in this volume describes how a REIT and its foreign shareholder are taxed in the US. In this chapter we will focus on the tax treatment of the foreign REIT investor in its country of residence. Specifically, we will describe the tax treatment of various types of Dutch REIT investors and the main tax considerations for French and German REIT investors.

Whether REITs are advantageous from a tax point of view depends not only on the US tax treatment, but on that in the investor's home country. In general, investment in a REIT appears to be tax advantageous for certain exempt European investors, such as Dutch pension funds and Dutch fiscal investment institutions. For most taxable corporate European investors, only investment in a domestically controlled REIT or an interest of less than 5 percent in a REIT whose shares are traded on an "established securities market" would be tax advantageous. In certain situations, investments in REITs by foreign investors may even lead to double taxation.

### What Is a REIT?

In order to accurately describe the Dutch tax treatment of a Dutch investor in a US REIT, it is necessary to characterize how the Dutch tax system would perceive a REIT. In this context, a REIT can generally be described as a US entity that owns interests in real property and or mortgages on real property and that derives income from these sources. A REIT can be established as a US corporation, trust or association. Other requirements for REIT status exist as well. For example, a REIT has to elect such status, it must have transferable shares, be owned by at least 100 persons and may not be closely held. Furthermore, it should meet certain income and asset tests, and make minimum annual distributions to its shareholders.

(Unless otherwise indicated, this discussion addresses the corporate form since most REITs are US corporations.)

## Considerations for Foreign Investors

### How Are the REIT and Its European Investor Taxed in the US? — Domestic US Tax Law

As indicated in Chapter 25, to the extent that it distributes its income and capital gains to its investors, the REIT itself is generally not taxed on this income. Although not engaged in a US trade or business solely because of their investment in a REIT, foreign investors are subject to US tax on their distributions, and may also be taxed on any capital gain realized upon a sale of their REIT shares.

A REIT's dividend distribution of operating income to foreign shareholders is subject to US withholding at a rate of 30 percent. REIT capital-gain distributions to foreign investors are taxed at the rates for capital gains (35 percent for corporate investors and 15 percent for individual investors). In addition (under the withholding provisions of the Foreign Investment in Real Property Tax Act of 1980, known as FIRPTA), a REIT is generally required to withhold from all capital gain distributions, with this tax creditable against the amount of tax ultimately due.

Capital gains realized upon the sale or other disposal of shares in a REIT are generally also taxable at the capital-gain rates. Moreover, the acquirer of the shares must withhold 10 percent of the gross purchase price paid (FIRPTA). Shares in a REIT held by a foreign investor can be transferred free of US capital-gains tax if the REIT can be considered "domestically controlled" or the shares in the REIT are regularly traded on an established securities market and the foreign investor does not hold more than 5 percent of the shares during a certain period.

## Considerations for Dutch Investors

### How Does the US Reduce Its Taxation Under the US-Netherlands Treaty?

Under the US-Netherlands treaty (the Treaty), US withholding tax on dividends distributed by REITs is reduced only if:

- the dividends are paid to an individual owning less than 25 percent of the shares
- the dividends are paid with respect to a class of stock that is publicly traded and the shareholder holds 5 percent or less of any class of the REIT's stock
- the dividends are paid to a shareholder holding 10 percent or less of the REIT's shares and no single interest in real property held by the REIT comprises more than 10 percent of the gross value of the total interest in real property held by the REIT
- the dividends are paid to a Dutch corporation that qualifies as a fiscal investment institution (*beleggingsinstelling*). In such cases, the domestic withholding tax rate is reduced from 30 to 15 percent.

Under a specific provision of the Treaty, dividends received by an exempt Dutch pension fund from a REIT (or from any other company) are not subject to US withholding tax (unless the income is derived from a US trade or business, or from a related person). Since 1993, the Treaty explicitly excludes "capital gain dividends" from this provision.

### How Is a Dutch Investor's Interest in a REIT Taxed in the Netherlands?

The Dutch tax system distinguishes between individuals and corporate investors, and within corporate investors between those normally subject to Dutch corporate income tax and those that are exempt from it.

#### *Dutch Individuals*

As long as a Dutch resident individual holds less than 5 percent of the shares in a REIT, the income from and or capital gains realized upon the alienation of the shares in most cases is not subject to Dutch income tax. Instead, the individual is subject to a 30 percent income tax on a presumed income on the shares amounting to 4 percent of their average value. Such taxation of REIT-derived income contrasts with the application of the general progressive Dutch income tax rate to (net) income and capital gains from more active, entrepreneurial investment in real estate.

If a Dutch resident individual (either alone or together with certain relatives) holds at least 5 percent of the shares in a REIT, the actual (net) income and capital gains are subject to Dutch income tax at a rate of 25 percent.

***Dutch Corporate Investors Subject to Tax***

In principle, any income earned or capital gains realized by Dutch corporate investors is subject to Dutch corporate income tax at the general rate of 25.5 percent (20 percent on the first €200,000). An exception is made for income and capital gains from certain qualifying shareholdings under the participation exemption. In general, the participation exemption is available for shareholdings in which the Dutch parent company holds at least 5 percent of the paid-in capital of the participation and the participation itself does not constitute a low-taxed passive subsidiary (LTPS) within the meaning of the participation exemption. As discussed below, most REITs do not meet the criteria for LTPS.

A REIT will not qualify as an LTPS if it meets one of the following three criteria:

- At least 50 percent of the assets of the REIT must be "active business assets." Since a REIT typically needs to invest in passive real estate investments, this test will probably not be met.
- The company must be subject to a tax on its profits which results in a levy at a rate of at least 10 percent of taxable profit calculated by Dutch standards. As the REIT itself will generally not be subject to such tax, this test too will likely not be met.
- At least 90 percent of the assets of the participation (on a consolidated basis) must consist of real estate within the meaning of the Dutch tax law.

Most REITs will meet this last test, in which case the participation exemption will apply.

***Dutch Institutional Investors and Fiscal Investment Institutions (Beleggingsinstellingen)***

Dutch institutional investors and investment institutions form a third category of investors. In general, Dutch pension funds are exempt from corporate income tax in the Netherlands. Dividends received from a REIT and capital gains realized upon the transfer of shares in a REIT will thus not be subject to Dutch corporate income tax in the hands of a Dutch pension fund.

Although strictly speaking, an investment institution is not exempt but subject to a special corporate income tax rate of 0 percent, an investment company's income from a REIT and capital gains realized from sale of REIT shares will be treated similarly. One of the requirements to qualify as an investment company in the Netherlands is that the investment company should hold only passive investments. On this basis, an interest in a REIT can be held by an investment institution.

**How Does the Netherlands Provide Relief for Double Taxation Under the US-Netherlands Treaty?**

The Treaty allows a deduction from Netherlands corporate income tax equal to 15 percent of the dividends received from a REIT. Standard US withholding of 30 percent in most situations will lead effectively to double taxation. Furthermore, the deduction cannot exceed the Dutch corporate income tax that would be payable on income from the REIT, if that income would have been the Dutch investor's only item of income. As an investment company is subject to corporate income tax at a rate of 0 percent, it cannot claim a credit. Under certain circumstances, an investment company may deduct from the Dutch dividend withholding tax (currently 15 percent) the 15 percent already withheld in the US. If the shareholder of the investment company is a resident that benefits from a reduced Dutch dividend withholding tax rate (pursuant to a tax treaty between the Netherlands and the country of residence), the deduction will in general be limited to the (reduced) treaty rate. This deduction means that effectively no Dutch dividend withholding tax would be due on any distribution from the Dutch investment company to its shareholders.

The Treaty allows the US (under the capital-gain article) to levy US capital-gain withholding tax at the normal rate on a "capital-gain dividend" distributed by the REIT. The Netherlands will treat any dividend (whether distributed out of capital gains or not) as covered by Article 10 of the Treaty, with the result that it will not exempt such dividends but only grant a 15 percent deduction. The distribution of a capital-gain dividend, therefore, may also lead to double taxation.

Generally under the Treaty, a capital gain realized upon the transfer of shares in a REIT may only be taxed in the US. The Netherlands exempts these gains even if such capital gains are not taxed in the US (which is the case with domestically controlled REITs and less than 5 percent interests held in listed REITs).

The following discussion of tax treatment in France and Germany highlights certain differences in tax treatment between the various EU member states. It is not meant to be a complete description of the tax treatment of various investors.

### How French REIT Investors are Taxed

A French individual is subject to French income tax at the normal progressive rates (a maximum rate of 52.1 percent, including social contributions) on 60 percent of dividends from a corporate REIT. The France-US treaty reduced withholding tax of 5 percent applies only to the extent that the individual holds less than 10 percent in the REIT, and it can be offset against the French income tax applicable to the dividend. Otherwise, the US domestic withholding tax rate applies, but again the US tax can be used as a credit against the French tax due on the gross dividend. Any excess over the amount of French tax due on the dividend cannot be used in France, however.

Capital gains upon the transfer of REIT shares, to the extent they are attributable to US real properties, are generally treated as gains on transfer of real properties located in the US and would accordingly be taxable in the US. French individual investors are also subject to French capital-gains tax at 30.1 percent (including social contributions), unless the REIT qualifies in France as a "real property company." In that case, capital-gains tax at 28.1 percent (including social contributions) on real estate would apply. Again, the US tax can be used as a credit but any excess cannot be used in France.

A French corporate investor is generally taxed on dividends received from a corporate REIT at the standard corporate income tax rate, which is 33.3 percent plus a 3.3 percent additional contribution in 2009. The US domestic withholding tax applies (the treaty provides no relief or reduction) and can be used as a credit against the tax due in France. Excess credit over the amount of the French tax on the dividends can generally not be used in France.

For French corporate investors too, capital gains realized on transfer of REIT shares, to the extent that they are attributable to US real properties, are generally treated as gains on transfer of real properties located in the US and are taxable in the US. French corporate investors are also taxable in France, generally at the standard rate of 33.3 percent plus a 3.3 percent additional contribution. However, if the long-term capital-gains tax regime applies and the shares can be considered a qualified participation (*i.e.*, they are treated as participation shares for accounting purposes, which generally requires at least a 5 percent stake), the rate would be 19 percent plus a 3.3 percent additional contribution. US taxes levied on the gains would be creditable against the French corporate income tax on that gain with excess credit unusable in France.

## Considerations for German Investors

### How Does the US Reduce Its Taxation Under the US-Germany Treaty?

Under the US-Germany treaty (the Treaty), as of December 28, 2008, US withholding tax on dividends distributed by REITs to a German investor is reduced (to 15 percent) only if the investor is an individual holding an interest of not more than 10 percent in the REIT, the dividends are paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividends is a person holding an interest of not more than 5 percent of any class of the REIT's stock, or the beneficial owner of the dividends is a person holding an interest of not more than 10 percent in the REIT and the REIT is diversified.

Under the Treaty, REIT dividends paid to a German pension fund are not subject to US withholding tax provided that they are not derived from the fund's active involvement in a business, direct or indirect, and if:

- the pension fund holds an interest of not more than 10 percent in the REIT
- the dividends are paid with respect to a class of stock that is publicly traded and the pension fund holds an interest of not more than 5 percent of any class of the REIT's stock
- the pension fund holds an interest of not more than 10 percent in the REIT and the REIT is diversified.

A REIT is considered "diversified" if no single interest in real property exceeds 10 percent of its total interests in real property, not including foreclosure property. Where a REIT holds an interest in a partnership, it is treated as owning directly a proportion of the partnership's interests in real property corresponding to its interest in the partnership.

"Pension fund" means any person established under the laws of and maintained in the Federal Republic of Germany primarily either to administer or provide pensions or other similar remuneration (including social security payments, disability pensions and widow's pensions) or to earn income for the benefit of one or more such persons. Contributions to pension funds must be eligible for preferential treatment under the German Income Tax Act (*Einkommensteuergesetz*).

### How Is a German Investor's Interest in a REIT Taxed in Germany?

Dividends and capital gains deriving from a US REIT are taxable under the German REIT Act (*REIT Gesetz*) provided the US REIT qualifies under that act as a foreign REIT. A US REIT qualifies as a foreign REIT if:

- it is not resident in Germany
- more than two thirds of its gross assets are immovable assets
- more than two thirds of its gross revenue derives from renting, leasing and the sale of immovable assets
- it is not subject to any investment supervision in the US
- its shares are traded on a regulated market
- its distributions resulting from real estate are not subject to prior foreign tax in the US comparable to German Corporate Income Tax (*Körperschaftsteuer*).

For individual investors, dividends and capital gains deriving from a foreign REIT and not qualifying as business income (*gewerbliche Einkünfte*) are, in principle, subject to German income tax (*Einkommensteuer*) at a flat rate (*Abgeltungsteuer*) of 26.375 percent (including solidarity surcharge). Capital losses deriving from a foreign REIT can only be offset against positive income deriving from the sale of stock. A net loss from capital investments can only be offset in future fiscal years. The flat tax does not apply where dividends or capital gains qualify as business income or where the shareholder held at least 1 percent of the shares in a foreign REIT at any time within the five years prior to the disposal. In these cases, dividends and capital gains are in general subject to income tax as the regular exemption for dividends and capital gains is not applicable. The regular exemption (Section 3 No. 40 of the German Income Tax Act exempts 40 percent of dividends and capital gains for individual investors partnerships and 95 percent of dividends for corporate shareholders as defined in Section 8b of the Corporate Income Tax Act) will be applicable with respect to dividend distributions of a foreign REIT originating in tax-burdened profit portions, but only if the burden reaches 15 percent. Capital gains on the disposal of shares in a Foreign REIT are fully taxable at the level of the investors, irrespective of whether they originate in tax-burdened profit portions.

Where shares in a foreign REIT constitute business assets of the investor, associated losses or expenses can be offset only against positive income from shares in German REITs or other foreign REITs. Remaining negative income associated with foreign REIT shares can be offset in the prior fiscal year, subject to further restrictions. Negative income still remaining can be carried forward to future fiscal years subject again to further restrictions. Expenses and losses in connection with dividends privileged under Section 3 No. 40 of the German Income Tax Act or Section 8b of the German Corporation Income Tax Act (including depreciation of shares in a foreign REIT due to such privileged dividends) are not taken into consideration for corporate investors and for individual or partnership investors only 60 percent of such expenses and losses are taken into consideration for German income tax purposes.

**How Does Germany Provide Relief for Double Taxation under the US-Germany Treaty?**

US tax paid on dividends paid by a US REIT or on capital gains on the sale of stock in a US REIT can be credited against German income tax, subject to German foreign tax credit provisions and the Treaty, as can tax paid on capital gains for which the Treaty would otherwise provide the exemption method (treaty override).

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# Chapter 24

## TAXATION OF FOREIGN INVESTORS IN US REAL ESTATE UNDER FIRPTA

Willys H. Schneider, Kaye Scholer LLP

The US federal income-tax treatment of foreign investors in US real estate is subject to a special set of rules, enacted as the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). These rules apply uniquely to real estate-related investments. Awareness of the FIRPTA rules is, therefore, critical for any foreign person contemplating an acquisition of US real property. Foreign lenders to borrowers securing loans with US real estate may also be affected by the FIRPTA rules.

Prior to FIRPTA, foreign investors in US real estate could elect, in years in which depreciation and other deductions minimized operating income from the realty, to be taxed as if they were engaged in a US business and then could revoke such election once taxable operating income was generated or in the year of a profitable sale. In addition, investors could avoid tax on appreciation of US realty held indirectly through corporations. FIRPTA prevents such avoidance on dispositions of appreciated US real property.

Under FIRPTA, foreign investors in US real property must pay US federal income tax on any gain recognized upon a sale or other disposition of "US real property interests" (USRPIs). The tax is imposed, at the rates applicable to US taxpayers, as if the investor were engaged in a US trade or business regardless of the actual extent of its activities in the US. Tax treaties typically do not protect against imposition of tax under FIRPTA.

USRPIs, dispositions of which are subject to tax under FIRPTA, include direct-ownership interests as well as interests in US corporations holding US real assets as a significant percentage of their total assets including interests in certain REITs. Interests in certain partnerships and trusts holding US real property may also be treated as USRPIs.

Generally, FIRPTA taxes gains on outright sales of USRPIs and on distributions (including in liquidation or redemption) of USRPIs by foreign corporations, with certain exceptions where the distributee would be subject to tax on a subsequent disposition to the same extent as in the corporate distribution. Dispositions of USRPIs in certain tax-free reorganizations, or in the context of like-kind exchanges for other interests in US real property, may be exempt from tax under FIRPTA, but only to the extent that any new property or stock interest received in such transactions would be subject to tax when ultimately disposed of.

Collection of tax under FIRPTA is enforced through a system of withholding rules, as well as by requiring the foreign investor to file a US income-tax return for the year of disposition. Any tax previously withheld is credited against tax due on such return.

## Definition of USRPIs (US Real Property Interests)

USRPIs on which gains are taxable under FIRPTA include interests in real property held in fee or through co-ownership, as well as leasehold interests in such property. A foreign partner holding US real estate through a partnership (or through a limited liability company treated as a partnership) is also taxable under FIRPTA on its share of any gain recognized upon the disposition of real property. Similarly, sales or other dispositions of certain interests in a partnership holding USRPIs, or of interests as a beneficiary in a trust or estate holding USRPIs, can be taxable under FIRPTA. An option, contract or right of first refusal to acquire an interest in US real property is also treated as a USRPI. Real property includes land (and unsevered natural products thereof, including crops, timber, mines and other natural deposits) as well as improvements, including buildings, bridges, storage tanks and bins. Certain personal property associated with use of real property is also included.

USRPIs include interests "other than...solely as a creditor." Thus, an interest in indebtedness secured by real property generally will not constitute a USRPI. Nor does a right to repossess or foreclose on real property under a mortgage security agreement financing statement or other collateral constitute a USRPI. Consistent therewith, a mortgagee in possession is not treated as holding a USRPI if its interest in the property is otherwise solely as a creditor. However, indebtedness that calls for some amount of interest determined by reference to gross or net proceeds or to profits generated by an interest in real property of the debtor (or a related person), or by reference to changes in value of such property (for example, loans with so-called equity kickers), will be treated as a USRPI. Thus, a foreign investor in such indebtedness will be taxed on any gain recognized on the disposition thereof (although this does not necessarily lead to tax on all interest in respect of such indebtedness). Deferred payments under an installment note received in return for a sale of US real property will also be taxable under FIRPTA.

A recent IRS ruling held that a swap, the return on which was calculated by reference to an index based on a broad range of US real estate data, was not a USRPI and therefore no payments therefrom would be taxable to a foreign investor under FIRPTA. Although limited to its facts (a broad-based index in respect of which the investor could not, as a practical matter, hold or lease a material percentage of the real estate involved), the ruling was significant in representing the first pronouncement of the IRS as to how FIRPTA interacts with tax rules governing swaps.

A US corporation that qualifies as a United States real property holding corporation (USRPHC) is also included as a USRPI. A USRPHC is defined, generally, as a corporation, the fair market value of the USRPIs of which equal or exceeds 50 percent of the fair market value of its USRPIs, its interests in non-US real property and any other of its trade or business assets. Assets held by certain subsidiary corporations are viewed as held by the parent for purposes of the foregoing determination.

A foreign investor is subject to tax on disposition of an interest in a US corporation unless either it can establish that at no time during the five-year period ending on the date of disposition (the "test period") did the corporation constitute a USRPHC or that on the date of disposition the corporation no longer holds any USRPIs and all USRPIs previously held during the test period have been disposed of in fully taxable transactions. The latter rule means that an otherwise taxable liquidating distribution from a US corporation will not be taxable if the distributing corporation has previously sold its USRPIs and paid tax on any gain recognized in such sale. This may make it more advantageous for a foreign person to invest in multiple US properties through separate corporations, thus enabling tax-free repatriation of after-tax proceeds on the sale of a single property. (If a single US corporation owns several properties, then a distribution of profits generated on the sale of a single property would likely constitute a dividend, which would be subject to US withholding tax.) Interests in publicly traded corporations, if the foreign investor does not hold more than 5 percent of such stock, or in a "domestically controlled" REIT, also are not treated as USRPIs.

## FIRPTA Withholding

### General Rules

FIRPTA includes a set of withholding rules to enforce collection of its tax. The general approach is to impose an obligation on purchasers of USRPIs to ascertain whether the seller is a foreign person and, if so, to withhold and pay over to the IRS a portion of the proceeds otherwise due the seller. Any amounts so withheld are credited against the tax ultimately determined to be owed by the foreign investor. Any amount withheld in excess of such liability can be claimed as a refund.

On a typical sale of a USRPI by a foreign person, the transferee generally must withhold and transmit to the IRS 10 percent of the consideration paid. The amount to be withheld can be reduced (or withholding excused entirely) if a certificate is received by the IRS indicating that the amount to be withheld would exceed the maximum tax ultimately due, or if the transaction is one in which no gain or loss must be recognized. In addition, no withholding is required of sales of residential real property where the sales price does not exceed $300,000 or where the transferor is a foreign corporation that has made an election to be treated as a US corporation for purposes of the FIRPTA withholding rules.

### Special Rules Applicable to Entities Owning USRPIs

Special withholding rules apply to distributions by entities that own USRPIs, and to dispositions of interests in such entities.

A domestic or foreign partnership, trust or estate who distributes a USRPI to a foreign partner or beneficiary in a transaction that is taxable under FIRPTA must withhold 10 percent of the fair market value of the distribution. In addition, a domestic trust or estate must withhold 35 percent of the gain it realizes upon the disposition of a USRPI, to the extent that such gain is allocable to a foreign partner or beneficiary, or to the portion of the trust treated as owned by a foreign person under so-called "grantor trust" rules. US partnerships must also withhold 35 percent of a foreign partner's share of gain attributable to the disposition of a USRPI. Finally, except in the case of certain publicly traded partnerships, if 50 percent or more of the value of a partnership's gross assets consists of USRPIs and 90 percent or more of its gross assets consists (directly or indirectly) of USRPIs and cash or cash equivalents, then 10 percent of the consideration received upon disposition of the partnership interest must be withheld.

A foreign corporation must withhold 35 percent of the gain recognized upon its distributions of USRPIs that are taxable under FIRPTA. A US corporation which is (or has been during the test period described above) a USRPHC must withhold 10 percent of the amount realized by a foreign shareholder upon certain distributions by the corporation to such shareholder.

The FIRPTA taxation and compliance rules are unique to US real estate. They have a significant impact on just about any real estate-related investment. Foreign investors will be well-advised to factor in taxes under FIRPTA in assessing their projected profit on an acquisition.

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# Chapter 25

# FOREIGN INVESTMENT IN REITS

Willys H. Schneider, Kaye Scholer LLP

## Characteristics of REITs

Real estate investment trusts (REITs) are corporations, trusts or other entities that fulfill certain statutory requirements and elect REIT status. Generally, a preponderance of a REIT's income must be derived from certain real property sources (including rents, proceeds of sales of real property and interests on obligations secured by real property), a preponderance of its assets must consist of interests in real property and or mortgages on real property, and the REIT must make minimum annual distributions to its shareholders. A REIT must have at least 100 shareholders and not be controlled by individuals and certain entities. An entity that qualifies as a REIT generally avoids entity-level tax, to the extent that distributions of operating income are made to investor shareholders. (Capital gains may be retained by the REIT and tax thereon paid at the entity level, with a credit to shareholders for payment of such tax, in respect of so-called "capital-gains dividends.")

Since they generally hold pools of real estate investments that can include equity ownership of varied properties and real estate-related debt interests, a key business advantage to REIT investment is instant portfolio diversification, without the need for due diligence in connection with specific properties or investments. This is a particularly valuable aspect of REIT investment for foreign investors. Ownership of publicly-traded REITs also provides liquidity. Finally, as described more fully below, foreign investment in REITs can be advantageous from a tax point of view.

## Taxation of Foreign Shareholders in REITs

Foreign investors who own direct equity interests in US real property (or interests in partnerships owning such property) may be deemed engaged in a US trade or business and, as such, taxed as US persons. Investment in a REIT stock, by contrast, does not trigger such consequences. Assuming no other US contacts, ownership of REIT shares will not result in a foreign investor being treated as a US person for US income tax purposes. A foreign REIT shareholder will, however, generally be subject to withholding tax on distributions of REIT operating income and, under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), to capital-gains tax on certain "capital-gains distributions," as well as on distributions in liquidation or redemption of REIT shares. FIRPTA will also tax foreign shareholders on gain recognized on sales or other dispositions of certain REIT shares.

**Operating Income**

Distributions of REIT operating income are generally subject to a 30 percent withholding tax (which may be reduced under an income tax treaty between the US and the shareholder's home country). For example, under the US/Germany income tax treaty, the 30 percent statutory withholding rate is reduced to 15 percent, assuming that the investor owns less than 10 percent of the REIT. The US/Netherlands income tax treaty reduces the withholding rate to 15 percent if the dividend is paid to a Dutch *belegginsinstelling* or to an individual owning less than 25 percent of the REIT, or if the dividend is paid with respect to publicly traded REIT stock and the beneficial owner of the dividend holds no more than 5 percent of the REIT. In addition, dividends of operating income received by an exempt Dutch pension fund are completely exempt from US withholding tax under this treaty. Some treaty rates, however, are less favorable than those applicable to dividends from non-REIT corporations (often reduced to 5 percent on dividends paid to holders of more than a 10 percent of share of the distributing corporation and 15 percent in other cases). The REIT must pay over any withholding tax to the IRS.

**Capital-Gains Distributions**

REIT capital-gains distributions (other than such distributions with respect to stock of a publicly traded REIT, no more than 5 percent of which is held, which distributions are taxed as are distributions of operating income) subject to tax under FIRPTA are taxed to a foreign investor at the generally applicable rates for capital gains (currently a maximum of 35 percent for corporate investors and 15 percent for individual investors). Capital-gains distributions are designated by the REIT as such and consist of distributions attributable to net capital gains from sales or other dispositions of US real property interests (USRPIs) held by the REIT. USRPIs can include real estate held directly by the REIT or indebtedness secured by real property that provides for contingent or participating interest. Under special FIRPTA "look-through" rules applicable to REITs, such distributions are treated as gains to the extent of a foreign investor's *pro rata* share of the REIT's capital gain. Under the FIRPTA withholding provisions, a REIT is generally required to withhold 35 percent of all distributions designated as capital-gains dividends at the time of payment to a foreign investor. The tax so withheld is available as a credit against the tax ultimately due. Tax treaties generally provide no relief from this tax on REIT capital-gains distributions.

**Other REIT Distributions**

Recently, the IRS stated that it will clarify that any distributions from a REIT attributable, in whole or in part, to gain from the sale of a US real property interest would be taxable to a non-US shareholder. Thus, all non-dividend distributions, including return-of-capital, redemption and liquidating distributions, are potentially taxable. This is apparently the case even if gain on a sale of shares would not be taxable, as in the sale of shares in a domestically controlled REIT, (described below). The regulations are to apply to distributions occurring on or after June 13, 2007.

**Tax on Disposition of REIT Shares**

In general, REITs (other than certain mortgage REITs as noted later) will be US Real Property Holding Corporations (USRPHCs) and, therefore, USRPIs. Thus, a foreign holder of REIT shares will generally, subject to the exceptions described below, be subject to tax on gain recognized upon a sale or other disposition of such shares. (REITs holding only indebtedness secured by real property that carries no right to share in gross or net profits from property of the debtor or a related person would not be USRPIs, and therefore capital gains recognized by a foreign investor on such shares should not be subject to US tax.) Gains on transfers of shares in REITs that are USRPIs will be taxable, in general, in the same fashion as are REIT capital-gains distributions — that is, at applicable capital-gains rates. In the case of sales of REIT shares, however, FIRPTA withholding is imposed by the buyer, at a rate of 10 percent of the gross proceeds paid, unless a certificate reducing or eliminating the requirement is obtained.

There are two important exceptions to the general rules taxing foreign investors on gains on sale or other disposition of REIT shares. The first exception is that there is no tax if the REIT shares are traded on an established securities market and the investor, which for this purpose includes certain persons related to the investor, owns no more than 5 percent of the REIT in question. An established securities market, for this purpose, includes a US securities exchange registered under Section 6 of the SEC Act of 1934, a foreign national securities exchange which is officially recognized, sanctioned or supervised by another governmental authority, or any over-the-counter market.

The second exception is that gain on disposition of a "domestically controlled" REIT is not taxable under FIRPTA, with domestic control meaning that less than 50 percent of the value of the REIT's shares is held, directly or indirectly, by foreign persons. (Distributions of appreciated USRPIs by domestically-controlled REITs will result in tax at the REIT level on the portion of the appreciation attributable to the "foreign ownership percentage," which is defined as the greatest percentage of foreign ownership of the REIT stock during a prescribed testing period.) This can make it particularly attractive for foreign investors to purchase REITs controlled by US persons although, as noted earlier, the IRS has recently ruled that non-dividend distributions from such REITs may be taxable to a non-US investor. At various points, there have been proposals that would tighten up the prohibition against closely held REITs. So far, none has made it into law, but any such change could make it more difficult to market tax-advantaged minority interests in domestically controlled REITs to foreign investors.

Investment in REITs can be advantageous from a business tax perspective. The prospective investor should make sure to factor in the potential US tax on the REIT return in evaluating a potential investment.

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# Chapter 26

## IMPACT OF STATE AND LOCAL TAXES ON FOREIGN INVESTMENT IN US REAL ESTATE

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A foreign investor considering the tax implications of an investment in US real estate typically focuses on US federal income taxes and ignores state and local taxes. There are a number of reasons for this, first and foremost of which is that federal tax rates are substantially higher than those charged by states and localities. The maximum federal income tax rate applicable to corporate and individual investors is 35 percent. Moreover, corporations face a second level of tax applicable to distributions (or deemed distributions) to shareholders imposed at the rate of 30 percent unless reduced by tax treaty.

Most state and local income tax rates, on the other hand, are less than one-quarter of the federal rates. State taxes are also deductible in computing federal taxable income, making the effective rate lower still. However, taxes on net income are not the only taxes levied by state and local governments. Some states tax gross income and others tax a corporation's capital employed in the state.

While almost all states have sales and use taxes (the latter apply to the sale or use of tangible personal property in the state), some also tax various services. Some jurisdictions also impose a tax on rents paid with respect to real estate located within their boundaries. Another type of tax imposed by many states and some cities and counties is a real estate transfer or recording tax. This type of tax is typically expressed as a percentage of the consideration received in connection with a transfer of real estate. Finally, *ad valorem* real estate taxes are imposed against the value of real estate located within the jurisdictional limits of many state and local taxing authorities.

The overall burden of state and local taxes within the context of foreign investment in US real estate can be significant. Perhaps more importantly, many of them are payable regardless of whether the taxpayer is making a profit. Foreign investors in real estate should also be aware that income tax treaties to which the US is a party (many of which reduce taxation of certain types of income and attempt to eliminate double taxation) do not typically apply to state and local taxes.

Finally, except for certain limitations in the US Constitution, no uniformity of taxation is required of US states and localities. This variation can create both pitfalls and opportunities. Attention to state and local tax planning will usually be rewarded.

## US Constitution

The power of states and their political subdivisions to levy taxes is derived from the US Constitution, which confers specific powers on the federal government and permits powers not so conferred to be exercised by the states. The Constitution also limits the powers of both federal and state governments. These limitations include the right to equal protection under the law and the right not to be deprived of life, liberty or property without due process of law. The due process clause is the principal protection against unlimited state taxation in that it requires a certain minimum level of contact between a person and a state seeking to impose a tax on that person and also requires that a state tax only that portion of a person's activities that are fairly attributable to that state. The courts have also cited the federal government's exclusive authority to regulate interstate and foreign commerce in limiting the exercise of state taxing power.

## State Income Taxes

Just about every state imposes some type of corporate and individual income tax. The principal focus of this discussion will be upon corporate income taxes, since most foreign investors do their investing through corporations. The highest state corporate tax rates generally range between 5 and 10 percent. While income taxes are for the most part imposed at the state level, some larger cities, like New York, impose them as well.

In order to be subjected to a state's corporate income tax, a corporation must typically be deemed to be doing business in the state or to own income-producing tangible property located there. Ownership of a direct interest in income-producing real estate within a particular state will almost always provide sufficient nexus for that state to tax the owning corporation. The indirect ownership of such real estate, however, such as through another corporation, will not usually result in taxation of the shareholder corporation. While the corporation that actually owns the real estate will be subject to tax, it may be possible to reduce that corporation's taxable income by making tax-deductible payments (such as interest) to the shareholder corporation.

Ownership of real estate through non-corporate entities such as partnerships, limited liability companies (LLCs) and trusts presents more complicated issues. Some states impose a tax on the income of the entity itself. Others tax the owners of the entity on their share of its income attributable to the in-state real estate. Still others differentiate between forms of ownership of the entity. For example, some states tax general partners' partnership income but not that of limited partners. Taxation of income of LLC interests is also not uniform across the states, although most states now follow the federal income tax classification rules for such entities.

As noted earlier, the variations between states' tax rules can present some tax-saving opportunities, among them the use of related-party debt. This mechanism has traditionally been used to reduce federal income taxes when the lender is a foreign entity resident in a country whose tax treaty with the US provides for a reduced rate of withholding tax on interest payments. This technique was curtailed somewhat by "earnings stripping" legislation enacted in the late 1980s but is still widely used. A variation is to establish a US corporation in a state (like Delaware) that does not tax passive income as long as the recipient corporation is not conducting an active business there, and then to have that company lend money to the company that owns the real estate. Some states (Ohio is an example) have enacted laws to limit the deductibility of interest on related-party debt. Others have tried to deal with the issue through unitary tax or combined reporting concepts or by treating the loans as sham transactions that should be ignored. Most states, however, have not been as aggressive as they could be in dealing with the issue. A foreign investor that owns real estate in jurisdictions in which related-party debt can generate state tax savings will, in most cases, need to use a separate corporation, rather than a tax-transparent entity like a partnership or an LLC, to own the real estate. While from a federal income tax standpoint this creates a more complicated structure, the ability to include the fiscal results of related domestic companies in a consolidated federal income tax return minimizes the complication.

If a corporation owns real estate in more than one state, its tax liability to each state is determined through allocation and apportionment rules. Allocation involves attributing all of the income from a particular activity, such as the ownership of real estate, to the state in which that activity occurs. Apportionment involves applying the percentage of the corporation's overall sales, payroll and property attributable to a particular state to its entire taxable income. Some states count each factor equally, some double count certain factors (typically sales), and some use fewer than three factors. Some factors, like payroll, can be manipulated, for example by hiring a management company to perform building services rather than using direct employees. The property factor is usually averaged in some way throughout the year, which can present tax-planning opportunities if a company plans to dispose of more than one property during a particular year. Disposition of property in a high-tax state early in the year and disposition of property in a lower-tax state later in the year will likely yield a lower overall state tax burden than if the order of sale were reversed.

A very simple example of the difference between allocation and apportionment would be that of a taxpayer who owns property in two different states, X and Y. Assume that both states tax income at 5 percent, but that State X allocates all income from real estate to the state in which the real estate is located and State Y uses a three-factor apportionment method. Finally, assume that the taxpayer has equal amounts of sales, payroll and property attributable to each state. If the property in State X is sold for a $100 gain and the property in State Y for a $200 gain in the same year, the tax payable in State X would be $5 (5 percent of the $100 of gain allocable to that state), and the tax in State Y would be $7.50 (5 percent of the 50 percent of the taxpayer's $300 taxable income apportionable to that state). In this example, the overall tax rate is 4.167 percent, even though the tax rates in both states are 5 percent.

By contrast, an effective tax rate higher than 5 percent would result if the locations of the gains were reversed. The tax payable in State X would be $10 (5 percent of the $200 gain allocable to that state), and the State Y tax liability would still be $7.50 (5 percent times 50 percent of the $300 taxpayer's total taxable income), for an overall effective tax rate of 5.833 percent.

Tax losses carried forward are usually determined differently at the state and local levels than at the federal level. Some jurisdictions have shorter carry-forward periods than those permitted for federal tax losses. In addition, most jurisdictions permit only losses attributable to activities in the state against income allocated or apportioned to the state. This can lead an investor with activities in more than one state to bear a much higher overall state income tax liability in proportion to its federal income tax liability than might be expected. An investor with properties in Illinois and New York, disposing of the property in Illinois in 2000 at a $100 loss and disposing of the property in New York in 2001 at a $100 gain, will have its federal taxable income in 2001 fully offset by the $100 loss carried forward from 2000. Its New York income tax liability, however, will be only partially offset because not all of the loss carried forward will have been attributable to New York activities.

Another issue that can arise is whether income from the sale of an interest in real estate constitutes "business" or "non-business" income. Many state and local tax systems differentiate between the two, taxing business income on an apportionment basis and non-business income on an allocation basis. If allocation is used, the income from the sale of a direct interest in real estate typically will be attributed in its entirety to the state in which the real estate is located, but income from the sale of an indirect interest, such as an interest in a partnership or an LLC, may be taxed in the owner's state of "commercial domicile," usually where its management is located.

It may be possible under certain circumstances to locate a corporation's management in one of the few states that does not impose any corporate income tax or in a state in which certain types of management activities do not cause a corporation to be subject to tax. Still another possibility is to locate the corporation's management in a state that taxes on an apportionment basis only, so that the only factor attributable to that state will be payroll.

Many foreign investors invest in US real estate through REITs. Although a REIT is subject to federal income tax, it is entitled to deduct from its federal taxable income distributions to its shareholders. The shareholders are subject to tax on the distributions. State tax treatment of REITs and their shareholders is not uniform, but most states permit deductions for distributions to shareholders regardless of whether the shareholders are subject to state tax on the distributions.

### State Capital Taxes

A number of states impose a tax based upon the capital a corporation is deemed to have employed in the states. Some of these impose the capital tax only when it results in a higher tax than the income tax. Capital is typically determined by subtracting the corporation's liabilities from its assets, but there are a multitude of methods for valuing assets, including book value and fair market value. Some states use a multiple of the value assessed for *ad valorem* taxes and others use a multiple of earnings over a specified period of time. A few states use a combination of these methods.

The definition of deductible liabilities is less varied, but some states exclude liabilities to related persons. Some treat deficits in retained earnings as liabilities. Like corporate income taxes, taxes on capital are subject to apportionment based on the corporation's activities in a state.

### State Taxes on Gross Income

The most prevalent state tax on gross income is the sales tax, traditionally imposed on receipts from sales of tangible personal property to the ultimate user. The concept of sales tax has been expanded in some states to include fees received for the provision of services. It can also take the form of a tax on rents or on the provision of utilities to tenants. In most cases, taxes on sales are the responsibility of the purchaser.

A few states and some cities and other local taxing authorities impose gross-receipts taxes on certain types of businesses carried on within their boundaries. These taxes are borne by the seller and are sometimes called license or privilege taxes.

One gross-receipts tax of particular relevance to real estate investors is that imposed on the consideration received in connection with transfers of real estate. These taxes are usually referred to as real estate transfer taxes, recording fees or deed stamps and vary from less than 1 percent of the sales price to as much as 3 percent. The obligation typically falls on the seller, but in some jurisdictions is split between seller and purchaser.

States or cities with higher transfer-tax rates often have a parallel regime under which consideration received for transfers of controlling interests in entities owning in-state real estate will also be subject to transfer tax. Since these indirect taxes are not collected by the officials who record deeds, as are direct transfers of real estate, they are not as easy to enforce, especially when the change of control takes place several steps removed from the entity which owns the real estate.

Finally, some states impose recording taxes on various real estate-related documents (such as long-term leases and mortgages).

### *Ad Valorem* Property Taxes

Owners of real estate located just about anywhere in the US must deal with *ad valorem* property taxes levied by local taxing jurisdictions such as counties, cities and special-purpose districts to finance services of a local nature, such as schools and fire and police protection. The rates tend to fluctuate depending upon budgetary requirements and are applied to the value of real property (and sometimes personal property) located within the taxing jurisdiction.

While all property taxes are based upon the value of the subject property, the manner in which that value is determined varies widely. Since the valuation of real estate is a somewhat subjective exercise, taxpayers often initiate legal proceedings to challenge valuations.

It is a fairly uniform practice across the country for tenants in leases of commercial real estate to bear the expense of property taxes. This can be accomplished by having the tenant pay the taxes directly, either into an escrow account or to the taxing authority, or by having the tenant pay additional rent when property taxes increase.

### Conclusion

While often overlooked, state and local taxes can have a real impact on the overall return of US real estate investments. However, the lack of uniformity in the rules governing the states' taxation of multi-state activities creates opportunities, not available at the federal income tax level, to manage the tax components of an investment.

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# Chapter 27

## CONSIDERATIONS REGARDING US ESTATE AND GIFT TAXES FOR NON-RESIDENTS' INVESTMENT IN US REAL PROPERTY

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In the US, three types of estate and gift taxes may affect a non-resident alien with US property at different times and in different ways: gift taxes for transfers of property during life, estate taxes for property owned at death, and generation-skipping transfer (GST) taxes for transfers of property either during life or at death.

Gift, estate and GST taxes are referred to as transfer taxes because they impose a tax on the transferor of property. Thus, the donor of a gift, not the receiver, is responsible for paying gift taxes; the estate of a decedent, not the receivers of the inheritance, must pay the estate taxes; and the person (or trust) who transfers assets to a grandchild (or to a trust for the grandchild) must pay the GST tax. These taxes are levied in addition to any real estate transfer taxes that may be due at the state or local level.

### General Guidelines for the Estate and Gift Tax

Subject to a few exceptions discussed below, a non-resident alien is responsible for US estate tax on any of his or her property "situated" in the US at the time of his or her death, and for gift taxes on transfers of such real and tangible property during his or her lifetime. Any real estate or tangible property located in the US is considered to have a US *situs*. Intangible property with a US *situs* includes stock in US companies, notes receivable from US persons payable to non-US persons, and certain retirement plan benefits if the sponsor or employer is a US person (unless the services provided by the non-US person were performed only outside the US). For both US estate and gift tax purposes, non-resident aliens are taxed at graduated rates currently ranging from 18 percent on the first taxable $10,000 to 45 percent on taxable transfers in excess of $1,500,000.

[1] A portion of this chapter is based on an article written by Todd E. Behrend of Deloitte and Touche for the 2003 edition of the *AFIRE Guide to US Real Estate Investing*.

In addition, certain US states impose their own gift or estate taxes for transfers of property with a *situs* in the state. These rates vary greatly. Florida imposes no gift or estate taxes, but the estate tax in New Jersey can be as much as 16 percent. Estate taxes paid to a state are deductible for federal estate tax purposes, but the availability of such deductions for state estate tax purposes varies.

**Estate and Gift Tax Treaties**

Currently, the US has entered into estate and gift tax treaties with Australia, Austria, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Sweden, Switzerland and the United Kingdom. The first step in any analysis is thus to see if a treaty would change the general US rules applicable to non-resident aliens. As is illustrated below, a non-resident alien domiciled in a country with an applicable estate tax treaty can encounter much more favorable estate tax treatment in the US than a non-resident alien without the protection of such a treaty.

**Gift Taxes**

US gift tax laws apply to all direct and indirect transfers of real or tangible property located in the US during the life of a non-resident alien. Unlike estate tax and GST tax laws, gift tax laws do not apply to a non-resident alien's lifetime transfers of intangible property such as stocks, bonds and notes. (Gift tax laws do apply to any lifetime transfers made by US citizens, regardless of the type of property transferred.)

***Annual Exclusion***

In 2009, the first $13,000 of lifetime transfers of real or tangible property by non-resident aliens per donee in each year is excluded from taxation, as is a similar amount of lifetime transfers of any type of property for US citizens. The amount of the exclusion is indexed for inflation. Unlike US citizens, non-resident aliens are not allowed to split gifts between spouses, an approach which would otherwise allow them to double the available annual exclusion.

***Gifts to Spouses***

A person married to a US citizen may make unlimited gifts to that spouse without incurring gift tax. Annual tax-free gifts to a non-US citizen spouse are capped at $133,000 (for 2009), an amount also indexed for inflation.

***Gift Tax Exemption Does Not Apply to Non-Resident Aliens***

Each US citizen has a lifetime gift tax exemption of $1,000,000 and may make gifts during his or her lifetime in the aggregate amount of $1,000,000 without paying any gift tax. No such exemption exists for non-resident aliens, however.

**Estate Taxes**

In general, the US gross taxable estate of a non-resident alien consists of all tangible or intangible property situated in the US in which the non-resident had an interest at the time of his or her death.

***Limited Estate Tax Exemption for Non-Resident Alien***

In 2009, each US citizen has an estate tax exemption of $3,500,000, reduced by any gift tax exemption used during his or her life. However, non-resident aliens are generally allowed only a $60,000 estate tax exemption. This means that, unless there is a treaty between the US and the decedent's home country, a non-resident alien decedent can transfer only $60,000 in US-*situs* property free of estate tax. Any additional US-*situs* property would be subject to estate taxes.

***Bequests to Spouses***

A non-resident alien is not entitled to a marital deduction unless the donee spouse is a US citizen on the date of the death of the non-resident alien. Exceptions exist for estate tax purposes if the surviving spouse was a resident at all times after the death of the spouse and becomes a citizen of the US before the estate tax return is filed, or if the property is transferred to a qualified domestic trust (QDOT). In both cases, the marital deduction is allowed and no estate tax will be due upon the non-resident alien's death (although they will be due upon the surviving spouse's death).

*Qualified Domestic Trust (QDOT)*

To qualify as a QDOT, a trust must have at least one trustee that is an individual citizen of the US or a domestic corporation. Such a trustee must have the right to withhold from a distribution from the trust, other than an income distribution, any US taxes imposed on the trust. In addition, the decedent's executor must make an election on a federal estate tax return to treat the trust as a QDOT.

**Generation-Skipping Transfer Taxes**

In addition to gift and estate taxes, the US imposes a generation-skipping transfer tax on transfers during life or at death to a beneficiary who is more than one generation younger than the donor or decedent. This tax would thus apply to lifetime or testamentary transfers to a grandchild, or to a trust providing for income to be paid to the surviving spouse with the remainder going to a grandchild at the surviving spouse's death. In the latter case, the GST taxes must be paid by the trust upon the surviving spouse's death, not upon the death of the non-resident alien who established the trust. GST taxes are substantial, and are levied in addition to any applicable gift or estate taxes. The lifetime annual exclusion rules discussed above apply to GST taxes as well as to estate and gift taxes.

**"Situated" in the US: *Situs* of Property**

For both estate and gift tax purposes, property must be situated in the US to be considered US property. The *situs* depends on the type of property and how it is held.

*Real Property*

The *situs* of real property is determined by its physical location. A foreign person who owns US real property and directly transfers it through an estate or as a gift will thus face US estate and gift taxes on the transfer. However, the value of the property, for estate and gift tax purposes, is reduced by any associated mortgage indebtedness.

*Tangible Personal Property*

Tangible personal property generally includes items one can touch, such as automobiles, artwork, personal items, jewelry and furniture. The *situs* of tangible personal property is also determined by its physical location. Thus, a non-resident alien's tangible personal property transferred through an estate or as a gift will be subject to US estate and gift taxes unless it is taken out of the US by the non-resident alien prior to the transfer.

*Lifetime Gifts of Intangible Property*

Generally, the transfer of intangible property during a non-resident alien's lifetime is not subject to gift tax. For example, a non-resident alien's lifetime gift of an interest in a foreign or domestic limited partnership that owns US real property will be exempt from US gift tax, as would a gift of stock in a US or foreign corporation. Likewise, a non-resident alien's gift of stock in a US or foreign corporation will not be subject to gift tax. However, intangible property with a US *situs* owned by a non-resident alien at death may be subject to an estate tax. A non-resident alien owner of such property can therefore significantly reduce the estate taxes owed upon his or her death by making lifetime gifts of the US-*situs* intangible property, particularly when family members are the beneficiaries of trusts that contain provisions designed to keep such intangible property out of their taxable estates.

*US Corporations*

For estate tax purposes, shares of a corporation are deemed to have *situs* in the jurisdiction in which the corporation is formed or organized. Accordingly, shares of a US corporation have US *situs* and will be included in the non-resident alien's taxable estate.

***Foreign Corporations***

In contrast to shares of a US corporation, shares of a foreign corporation are exempt from US estate taxes since they are deemed to have *situs* in the country where the corporation is organized. For both estate and gift tax purposes, a foreign corporation is the preferred structure for a non-resident alien to own US real property, provided that the IRS does not treat the foreign corporation as merely a conduit or disregard it as a sham. A common estate planning technique is for a non-resident alien to form an offshore company to hold US-*situs* assets. While this approach can effectively eliminate exposure to US estate tax, there is a trade off involving US income taxes due to the possible application of the Foreign Investment in Real Property Tax Act (FIRPTA) rules and to the difference between individual and corporate tax rates on capital gains. Companies should always analyze estate tax savings from using an offshore company and the projected US income tax consequences of such a structure.

***Real Estate Investment Trusts (REITs)***

Despite their name, REITs do not fall under the definition of a trust for US tax purposes. Instead, a REIT is treated as a corporation. Therefore, owning shares of a REIT is treated the same as owning shares of any other US corporation for estate tax purposes, including being subject to estate taxes at the owner's death.

***Limited Partnership and LLC Interests***

The law is not entirely clear regarding the *situs* of a limited partnership interest for US estate tax purposes, and taxpayers must turn to other sources. An existing IRS ruling and early US estate tax treaties determine *situs* of a limited partnership interest by whether or not the limited partnership is engaged in a US trade or business regardless of where the limited partnership is organized or the extent of the US business activities. Since owning and operating US rental property is generally regarded as a US trade or business, a limited partnership or LLC is not especially helpful to foreign real estate investors who want to avoid US estate taxes. In addition, if provisions in the partnership agreement or applicable local law deem a limited partnership to terminate upon the death of a partner, a non-resident partner would likely be treated as the owner of his or her share of the partnership's assets and *situs* rules would apply. If the underlying US real property is disposed of before the death of the non-resident owner, US income tax laws require that any gain realized on the disposition be treated as if connected to a US trade or business. The same rules apply to a non-resident member holding interests in an LLC.

***Planning with Trusts***

The use of trusts is common in US estate and gift tax planning. Generally, the *situs* rule for trusts differs for estate tax and gift tax purposes. If a non-resident alien creates a trust that holds US real property, the applicable *situs* rule for gift tax purposes will depend on the type of trust employed. In a revocable grantor trust (one in which the grantor retains rights and powers over the trust assets), the non-resident grantor is treated as the owner of any US real property held by the trust. Thus, the transfer of property by the non-resident grantor to the trust will not be subject to US gift taxes, but any transfer the non-resident grantor makes of his or her interest in the trust will be subject to the US gift tax. In an irrevocable non-grantor trust (one in which the grantor retains no rights or powers over the trust assets), the non-resident alien is not treated as the owner of any US real property held by the trust and is not subject to US gift tax on the transfer of his or her interest in the trust. However, transfers of property by the non-resident alien to the trust may be subject to US gift taxes, depending on the nature of the transfer.

A trust is treated as a separate legal entity for US estate tax purposes. Thus, the general rule is that the settlor and the beneficiaries of a US trust will not be treated as the owners of the assets held by the trust. However, certain exceptions apply to US citizens and non-resident aliens alike. Specifically, if a decedent makes a gift of US property to a trust within three years of his or her death, the property will be included in his or her estate for US estate tax purposes, as will any lifetime transfers of property to a trust in which the decedent retained powers over those assets. An irrevocable non-grantor trust may provide a viable option for avoiding US estate taxes. However, the non-resident alien must be willing to give up all rights, powers and interests in the US real property donated to the trust.

If a non-resident alien has family members who are US citizens, there are significant estate and GST tax-planning opportunities involving lifetime gifts and US trusts for family members. These trusts can be structured so that the assets they own would not be subject to transfer taxes upon the death of the donor or the beneficiaries.

## How to Apply These Rules

The following are two simple examples that demonstrate application of the general rules discussed above.

### Applying the Gift Tax Rules — Gift of Direct Interest *versus* Partnership or LLC Interest

Peter, a resident of Hong Kong, wants to invest in an office building located in Chicago, Illinois. He has the choice of owning the building directly or forming a limited partnership or LLC to own the building. Peter plans eventually to give the property to his daughter, also a resident of Hong Kong. He decides to buy the building directly and 10 years later gives the property to his daughter. Unfortunately, the transfer of direct ownership of tangible property located in the US is subject to the US gift tax (although the state of Illinois does not impose a gift tax). If Peter had invested in the property through a partnership structure or LLC, he would have been deemed to own an intangible asset and the transfer of his partnership interest (or of his membership interest in the LLC) to his daughter would not have been subject to the gift tax.

If Peter decided to give his direct interest in the building to his grandchild instead of to his daughter, the transfer could be subject to the generation-skipping tax as well. Moreover, even though Peter had initially purchased the building directly, if he had transferred it to a partnership or LLC before making a gift of the partnership or membership interest to his daughter or a grandchild, he would have avoided gift or GST taxes.

### Applying the Estate Tax Rules

Gabriele, a German resident, is a sophisticated investor knowledgeable about the US gift tax rules. Gabriele invests in a US limited partnership that owns a shopping center in Orlando, Florida. Each year through the partnership, Gabriele receives her share of cash and rental income from the operations of the center. She plans to transfer her interest to her son during her lifetime since it would not be subject to gift tax. Unfortunately, she dies before she has a chance to make the planned gift. The interest in the partnership becomes part of her US taxable estate, subject to the US estate tax because the partnership interest is considered US-*situs* intangible property.

Based on 2009 tax rates, if the partnership interest has a value of $310,000 Gabriele's estate would owe approximately $70,800 in federal estate tax (after taking into account the $60,000 applicable exclusion available to non-resident aliens). (Note that Florida imposes no estate tax.)

However, because of the US-German estate tax treaty, Gabriele's estate would get a credit on her German estate tax return for any US estate taxes paid, and her US estate would be eligible for a portion of the exclusion available to US citizens.

The exclusion amount available to Gabriele's estate would depend upon the value of her US assets relative to the value of her worldwide net assets. Accordingly, if the partnership interest represented 10 percent of the total value of her worldwide net assets, Gabriele's taxable estate would be reduced by $350,000, resulting in a complete elimination of the US estate tax liability. (Many non-residents may be reluctant to disclose their worldwide assets to the US government, however, and may choose not to take advantage of this benefit.)

### Legislative Developments

As of this writing, there is uncertainty regarding the future of the US estate tax. Under the law in effect on June 30, 2009, there will be no US estate tax in 2010. In 2011, however, the estate tax is scheduled to be back in full effect with an exclusion of only $1,000,000 for US citizens. Publicly, President Obama has stated that he would like to see the US gift and estate taxes frozen at 2009 rates and exemption levels. However, no bill has been introduced to that effect. Most US estate planning professionals predict some sort of legislative action in 2009 and that the 2010 temporary repeal will not be allowed to occur.

The US estate and gift tax laws applied to foreign investors in US real estate are complex. When combined with those of a foreign country, the tax burden on investors who transfer real estate investments to their heirs can be substantial. Proper consideration should be given to these various consequences to maximize the tax efficiency of an investment.

Foreign investors in US real estate should give strong consideration to the use of trusts or foreign corporations as intermediate vehicles through which to hold their investments, although insertion of additional entities may cause additional income taxes. Many foreign investors choose to absorb these current costs in order to avoid having to report their worldwide holdings to the US government, as would be required upon the death of a direct holder of a US real-property interest. Investors undertaking such a trade off should weigh the future estate and gift tax benefits of these structures against the potential current income tax costs.

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# Chapter 28
## ENFORCING REAL ESTATE AGREEMENTS IN THE COURT SYSTEM

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There is no doubt that enforcing agreements in the court systems of the US is a complex, time-consuming, expensive, inconvenient, unflattering and often uncertain business. This is a fact of particular concern to foreign investors in US real estate, because such investments naturally are based on various kinds of contracts. Joint-venture agreements, brokerage agreements, purchase and sale agreements, leasing agreements, loan agreements, title insurance policies, construction contracts, and asset-management and property-management agreements are only some of the contracts typically required for such investments. Parties entering into such contracts naturally focus on ensuring that they accurately reflect the agreed-upon allocation of rights, risks and obligations. Given the high stakes and substantial amounts of money involved, however, it is also important to consider what will ensue in the event that either party breaches the agreement, and if litigation follows. Meanwhile, real estate investors and tenants will at times find it necessary to resort to the federal bankruptcy court, a separate system designed, at least in theory, to provide debtors suffering from financial distress with a "fresh start" enabling them, sometimes to the detriment of lenders and landlords, to re-cast their obligations.

### Litigation as a Part of Doing Business in the Commercial Real Estate World

Speaking at the broadest level of generality, participants in the commercial real estate business in the US must be ready, or at least willing, to litigate. For better or worse, litigation is often a necessary part of doing business in this arena. Litigation over all manner of real estate disputes is common. Ready resort to the courts is a time-honored and well-accepted way of resolving disagreements about business arrangements, and of seeking to allocate (or re-allocate) the costs and other burdens of any problematic set of circumstances. Sophisticated parties who invest in real estate in the US generally do consider the risk of litigation to be a predictable, if unfortunate, byproduct of being "in the game."

This anticipation of litigation, or at least of the reasonable prospect of litigation, is reflected in increasingly complex contract documents that address in ever greater detail such matters as choice of law, choice of forum, the requirement (or not) to pursue some form of alternative resolution in the event of a dispute, methods for calculating damages in the event of a breach, the availability of injunctive relief and other equitable remedies, waivers (or not) of punitive damages, and the recovery of litigation fees and costs by the prevailing party in any suit. Indeed, some real estate agreements seem to have been written by parties fully expecting from the very outset to wind up in court. In many situations, experience has shown that such anticipation is entirely appropriate.

The impact of this litigious culture on the enforcement of real estate agreements can be seen as both positive and negative. On the positive side, the value and usefulness of any contract is based on the willingness of the contracting parties to honor their respective promises. When business pressures become intense, often due to changed circumstances (such as widespread economic stress), that commitment can become strained, sometimes to the breaking point. It is then that the willingness of any party to continue to honor its contractual commitments is naturally influenced by consideration of the negative consequences that can be expected to accompany a breach. The very real prospect of being sued is one of the most obvious and significant negative consequences. Accordingly, parties under pressure often honor their contractual commitments at least in part because they are motivated by a keen desire to avoid litigation. The expense and other negative factors associated with litigation may be a heavier burden for a party to bear than the cost of complying with contractual obligations. Given the many downsides of a court fight (to say nothing of the often enormous expense), a party may conclude that it is better off meeting its commitments than being sued for failure to do so.

On the negative side, the prospect of litigation can also work the other way, and embolden a party to breach an agreement. Typically, it is the very same considerations of expense, delay, inconvenience, uncertainty and adverse publicity that support a party's decision to take a chance and fail to keep its promise. A breaching party may conclude that it will likely avoid any sanction for failing to meet its commitments, calculating that its counterpart would rather accept the business loss caused by the breach than pursue the matter in court, precisely because bringing suit presents the plaintiff, as well as the defendant, with the burdens of expense, delay, inconvenience and adverse publicity.

The fact that litigation is frequently used to impede and delay a party in pursuit of its business goals in the US is readily apparent. This phenomenon is particularly evident in the area of land-use litigation, involving appeals from the grants of special permits and variances by local zoning boards. Neighboring landowners or others who claim standing to challenge a development project may impede or even prevent a development project altogether simply by filing a court appeal because the mere pendency of litigation, regardless of the ultimate merits of the case, can halt the project.

Interested citizens are generally very well aware that the effect of filing such a permit appeal is a critical roadblock to any project. As one Massachusetts developer has commented, "We operate in a world where any idiot can bring a multi-million dollar development project that a community wants and needs to a grinding halt for the price of postage stamp [the cost of mailing a permit appeal]." This is unfortunately all too often true. In Massachusetts, as in many other states, it frequently takes several years for a civil case to get to the trial stage, factoring in the initial pleadings phase, pre-trial discovery and motions. If a judgment in the trial court is appealed to the appeals court, the process can easily take another two years or more. Only developers with sufficient stamina and deep enough pockets to persevere for years, market cycles notwithstanding, can effectively do business in this environment.

Developers are the not the only participants in the world of commercial real estate adversely affected by litigation. Disputes involving all of the various contracts typically used to accomplish real estate transactions are subject to resolution in the courts. Joint venturers may have differing goals and interests that lead to litigated disputes about their common undertaking; real estate brokers may litigate disputed claims for commissions; real estate buyers or sellers may have second thoughts about a proposed transaction and seek to litigate their way out of an agreement; landlords and tenants may litigate disputes about their respective rights and obligations under lease agreements; owners and lenders may litigate over financing terms; policyholders may litigate with title insurers over coverage disputes; owners and contractors may litigate over construction defects, cost overruns, delays or payment issues; owners and property managers may litigate disputes over any number of issues; and on and on and on. In short, litigation is a familiar item in the toolbox — and a recognized pressure point — that interested parties use with some regularity to achieve their business goals (or to stymie their adversaries) in the world of commercial real estate.

Of course, while the prospect of litigation is an important determinant of business conduct, it is difficult to predict at the outset of a contractual relationship just how that prospect will influence the relationship. Despite the uncertainty, however, the possibility that intractable disputes may later arise usually colors any contract negotiation. Each party's sense of whether it is more or less likely than the other party to seek an "exit strategy" from the contract in the future affects its negotiation of provisions for the termination of the agreement and for the consequences, including details of dispute resolution that will follow a breach, or a claim of breach. Ultimately, those provisions will impact the dynamic and the outcome of any litigation arising under the contract.

## Barriers to the Quick, Efficient and Predictable Enforcement of Rights

Where courts are ready, willing and able to enforce contracts, and where parties can obtain judicial enforcement of contracts without undue expense, delay and uncertainty, breaches are discouraged, business procedures are facilitated and investment-related expectations are protected. Where the court system does not function efficiently, or where parties are uncertain or unhappily surprised about the costs and consequences of enforcing agreements in the court system, the value of an investment can be damaged dramatically and a contract may ultimately seem to be worth little more than the paper on which it is written. It is thus generally understood that states where the barriers to quick and predictable resolution of contract disputes are lower will be seen as having a climate more conducive to business than other states. Despite this recognition, however, many states have a difficult time reducing barriers.

Given the significant negative consequences of litigation, and each state's interest in encouraging business within its borders, one might ask why the courts do not function more efficiently to produce prompt, efficient and predictable results for parties embroiled in contract disputes and other types of civil litigation. There is no simple answer, as there are a number of fairly intractable barriers to the quick, cost-effective and reliable judicial enforcement of private rights. Among these barriers are institutional causes of delay, due to funding shortages or management problems within the courts; the extraordinary expense of hard-fought civil litigation where big stakes are involved; and the variability of litigation results, which is especially notable in jurisdictions that do not enjoy the advantage of consistently experienced judges steeped in business-law issues.

**Institutional Cause of Delay and Timing Variations Across Jurisdictions**

Most real estate cases in the US are pursued in the state court system. This is because the federal court system has limited jurisdiction and is available only for cases involving questions of federal law or involving parties of diverse citizenship where over $75,000 is at issue. Real estate contract disputes commonly involve questions not of federal law but of states' common law of contracts, real property, torts or corporate law, or pertinent state statutes. The alternative basis for federal court jurisdiction, diversity of citizenship, is not always available.

The fact that most real estate disputes are resolved in the state court system is significant because state courts generally lack the financial, technological and various other types of resources available to federal courts. Predictably, over-burdened state courts are often slower than federal courts to decide cases. Accordingly, justice may simply take longer in state court than it does in federal court (although this is not the case everywhere).

One of the complicating factors about dealing with real estate on a national level is that the time it takes to get a real estate case resolved in court may differ significantly from jurisdiction to jurisdiction, and between state and federal court within a given jurisdiction. It is often difficult to get reliable and current information about such differences, which can be a critical consideration. There is no substitute for seeking the advice of experienced litigators within the jurisdiction where a property or a deal is based, or in the forum which provides the governing law under a given contract. It remains the case, however, that the time that it will take to litigate any contract dispute is inherently unpredictable and subject to the influence of myriad variables, uncertainty that no amount of expert guidance can eliminate. It also remains true that the time it takes to resolve a contract case in any state court is usually much too long to suit at least one of the parties, more frequently both or all of the parties.

**The Costs of Litigation**

The costs of litigation, particularly sophisticated business litigation involving real estate contracts and other complex matters, are very substantial and notoriously difficult to cap or even predict. Private litigants typically pay litigation counsel on an hourly basis, at rates that in the largest metropolitan centers have risen dramatically in recent years. In complex civil cases, substantial resources are frequently devoted to researching and litigating not only the governing law but an array of procedural issues because, as a practical matter, questions of procedure can often be every bit as important in determining the outcome as the substantive legal precedent. Expansive discovery rights and inefficiencies in the court system only serve to escalate the costs of litigation further. For example, a party may incur the substantial cost of preparing for a complex and lengthy trial, perhaps including travel for out-of-town expert witnesses, only to have the trial rescheduled at the last moment by the court. Such an occurrence will require a whole new round of intensive preparations when the case is again called for trial, perhaps many months later. This phenomenon is all too common in state courts within the US.

Moreover, the costs of complex business litigation are difficult to predict and contain, even with the assistance and guidance of experienced counsel. This is true in large part because any litigation effort is driven not only by its own preparation plan, but also by the need to respond to discovery requests and motions by the opposing party, to requirements imposed and orders issued by the court, sometimes to significant newly discovered facts or changed circumstances. Moreover, litigating parties with deep pockets sometimes try to outspend their opponents in litigation, waging a war of attrition, or perhaps more benignly, simply to produce superior work product that will be more persuasive to the ultimate decision maker. In any event, complex civil litigation is very expensive, and unpredictably so. Disputes arising over contracts involving real estate are certainly no exception to this rule.

### Inconsistencies in Litigation Results

Another of the complications and frustrations of dealing with contract disputes in the US is that contract litigation may progress very differently, and produce substantially different results, depending on the forum in which a case is brought. This is true both between judges on the same court, and across courts in different states, between state and federal court, and between district, circuit and appellate level. In some quarters, for example, there is a perception that federal courts are more inclined than state courts to dispose of cases at the summary judgment stage, based on a determination that there is no genuine issue of material fact and that judgment should be entered for one or the other party as a matter of law. Such perceptions naturally tend to lead to forum shopping by litigants. Many cases, however, are eligible to be brought in only a single forum. Where this is so and a party has comparable cases or similar contracts in different jurisdictions, inconsistencies are particularly frustrating.

Some jurisdictions have established special business courts to handle complex commercial cases, which often require specialized knowledge. The Delaware Chancery Court, for example, handles only non-jury cases seeking equitable relief and has a long tradition and a well-established reputation as a leader in business jurisprudence and a hospitable forum for business litigants with complex disputes. A number of states (often in limited geographic areas) have adopted specialized business litigation tribunals within the past decade or so.

It is reported that justice moves more swiftly in these specialized business sessions, and a higher percentage of cases settle before trial, than in other civil sessions. Business litigants generally prefer the quality of justice they receive from specialized business litigation courts and find the results more predictable, consistent and rational. Not only are such tribunals not available everywhere, however, in some instances they are not available for all categories of commercial cases. In each jurisdiction where litigation is anticipated, it is worth inquiring of litigation counsel whether a specialized business forum will be available.

## Alternative Dispute Resolution

Various methods of dispute resolution, most notably mediation and arbitration, have been used with increasing frequency in recent years as an alternative to traditional litigation for resolving complex business disputes. In mediation, the opposing parties confer privately with the assistance of a trained mediator, who facilitates settlement discussions and tries to assist the parties in reaching their own resolution of a controversy. In arbitration, one or more privately retained decision makers renders a binding decision, in an expedited private proceeding that typically involves limited pre-hearing discovery and abbreviated motion practice, followed by an evidentiary hearing.

The advantages of mediation and arbitration are considerable, in comparison to the experience of full-blown litigation in the courts. Generally, alternative dispute resolution (ADR) methods allow parties to resolve their disputes more quickly and less expensively than does litigation. In addition, the resolution will generally remain confidential and neither party will have its private business arrangements revealed in a public forum, as happens in litigation.

Certain disadvantages to ADR must be weighed, however. First, a mediated solution inevitably requires compromise, and an aggrieved party that wants the rightness of its position unequivocally and publicly established or that at least wants its "day in court," may prefer to takes its chances in the courts. (Of course, business litigants with complex, essentially economic, disputes are much less likely to take this view than individuals embroiled in controversies that involve matters of personal principle and reputation.) Likewise, there is a perception, correct or not, that arbitration decisions tend to "split the baby" rather than delivering an unequivocal victory to one side or the other, which may be considered a disadvantage.

There is also a more subtle public policy concern about ADR that stems from its inherently private nature. The very confidentiality that most business litigants find appealing about ADR may also have a detrimental long-run impact on the business community at large. ADR providers offer a system of private justice that does not result in publicly available judicial opinions with reasoned explanations for the results in specific cases. As a result, the continuing development of a generally understood body of "business jurisprudence" is hampered and the business community is deprived, to some degree, of the benefit of current and evolving legal precedent, which may guide it, in new disputes in new contract negotiations. This may increase the potential for good-faith disputes to arise in areas where the rules of law are not clear, widely understood or fully developed, or have not been revisited for many years.

This consideration may be of particular significance for certain kinds of business disputes. Where one party has an institutional interest in establishing a favorable, public precedent on a particular legal issue likely to recur with some regularity for example, a judicial forum may be preferable to ADR, despite the increased delays, costs and risks. Moreover, where the availability of a business litigation session enables the parties to know which judge or judges will likely hear their cases, there may be a greater sense of predictability about the course of the proceedings than exists in the ADR context.

## Legal Principles for Challenging and Constructive Agreements

State law typically determines disputes over the interpretation and application of real estate contracts in the US. While the law varies from state to state, a number of basic common law principles are generally applicable to contract disputes in American jurisdictions. None of these is universally applicable, and there are various refinements and exceptions that may pertain to any particular case. Still, it is helpful to have a general sense of the typically applicable principles, a few of which are outlined below.

First, as courts faced with contract disputes have been asked to construe what the parties meant by various phrases and terms, litigators for the disputing parties typically offer diametrically opposing (and sometimes quite creative) interpretations. One of the oldest concepts used in the US to resolve such disputes is that if the meaning of the contract can be clearly ascertained from the "four corners" of the document, a court will determine the contractual intent from the written provisions of the contract and go no further. Under this rule, evidence of the parties' negotiations and the drafting history of the contract will not be admitted or considered by the court, unless the contract is deemed to be ambiguous. This rule, which has been the law in most states for generations, can prevent frustration of the parties' clear intent.

Another basic rule on which courts in the US often rely is that ambiguities in a contract will be construed against the party who drafted the document. This notion has become somewhat antiquated in most commercial transactions, where final agreements generally reflect substantial input by attorneys for both parties. It is not unusual, in documents prepared by sophisticated parties and counsel, to see language that preempts this rule by expressly providing that the document shall not be construed against either party because it was jointly drafted by two parties with experienced, competent counsel. Meanwhile, a California statute provides that "technical words in a contract must be interpreted as usually understood by persons in the profession or business to which they relate, unless clearly used in a different sense."

When parties simply omit from their contract a term which must be determined in order to rule upon the adequacy of one of the parties' performance, the general rule is that a court will supply a term reasonable under the circumstances. For example, where no time for performance is specified in a contract, it must be performed within a reasonable time after execution. What is a "reasonable time" will depend on the nature of the contract, the probable intention of the parties and the attendant circumstances.

Where two parties have signed a fully integrated contract, evidence of prior or contemporaneous agreements is inadmissible to vary or contradict the terms of the final and complete written agreement. The basic tenet underlying this rule is that if a court finds the written agreement to have been intended as a complete and exclusive statement of the terms of the parties' agreement, then the writing alone constitutes the contract, and evidence of prior negotiations or side agreements will be ignored in interpreting the final written agreement. Most legal documents will, in fact, contain an "integration" clause which states explicitly that the document constitutes a complete statement of the parties' entire agreement and that prior writings will be ignored. So in a case where two parties sign a letter of intent for the purchase of an office building and later execute a formal contract, the letter of intent will be ignored in case there is a dispute between the parties as to their intentions. Where a letter of intent is not followed by a formal contract, however, a court may find that the parties are bound by the terms set forth in the letter of intent. This is particularly so in cases where the letter contains no specific language denying the formation of a contract unless and until a detailed formal document is signed.

## BANKRUPTCY

The main purpose of the US bankruptcy code, administered exclusively at the federal level to create consistency among the 50 states and the District of Columbia, is to provide debtors burdened by debt with a "fresh start." Two concepts in the code facilitate this fresh start: the automatic stay that arises upon the filing of a bankruptcy petition and halts, among other things, all collection actions of creditors and a discharge of all debts that arose before the petition date.

### Background/Process

#### *Reasons for Filing for Bankruptcy Protection*

A debtor that is insolvent because its liabilities exceed its assets may consider filing for bankruptcy. A debtor that is solvent on a balance sheet test but is unable to pay its debts as they become due may also seek bankruptcy protection. In addition, a debtor may choose to file for bankruptcy because the automatic stay prohibits creditor harassment and enjoins most creditor actions against the debtor while it seeks approval of a reorganization plan that will enable it to emerge from bankruptcy and continue its business operations.

#### *Determining Under Which Chapter to Seek Relief*

A business (including a general or limited partnership, joint venture, corporation or limited liability company) can file a bankruptcy petition under either Chapter 11 or Chapter 7 of the bankruptcy code. Chapter 7 is filed by a business that no longer intends to operate, and chooses to liquidate its assets. Chapter 11 is most often filed by a business that chooses to reorganize its financial affairs. A Chapter 11 reorganization may include liquidation.

*Automatic Stay*

Filing a bankruptcy petition triggers an automatic stay that prohibits any creditor from attempting to collect from the debtor or the debtor's property. This powerful tool not only prohibits collection activities, but generally requires anyone holding property of the debtor to turn that property over to the debtor-in-possession or trustee. If a creditor willfully violates the automatic stay, a court may award punitive damages and other severe relief. A creditor may seek from the bankruptcy court relief from the automatic stay to gain possession of its collateral and to liquidate the collateral to satisfy its secured claims. The bankruptcy court will consider various factors in determining whether to grant such relief.

*The Debtor*

In a Chapter 11 case, the debtor usually stays in control of its business or affairs. The goal of a Chapter 11 case for a debtor is to confirm a plan of reorganization. The plan will describe the treatment that creditors will receive.

*US Trustee*

The US Trustee is charged with overseeing all bankruptcy cases. A representative of the US Trustee's office conducts a meeting of creditors. The US Trustee's office may also take an active position in the case.

*Creditors' Committee*

The US Trustee often appoints a creditors' committee soon after the filing of the case. The committee generally consists of those persons holding the seven largest claims against the debtor or the seven largest amounts of equity securities of the debtor. The committee and its professionals (such as attorneys and accountants) will be entitled to reimbursement of their expenses if they can show that they were beneficial to the estate. Among other activities, the committee consults with the trustee or debtor concerning the administration of the estate and participates in the formulation of a plan of reorganization.

*Bankruptcy Process*

The bankruptcy case commences with the filing of a petition by the debtor (or, as discussed below, the filing of an involuntary case). After filing of the petition, a notice of the filing is sent to all creditors and other parties of interest. The notice also sets the date for a meeting of creditors, to be conducted by the US trustee who examines the debtor or its representative under oath. The meeting of creditors allows them to examine the debtor as well.

Once the petition is filed, the automatic stay becomes effective and prevents the continuation or commencement of any actions against the debtor or its property. If a lease has been terminated prior to the filing but the tenant/debtor remains on the premises, the automatic stay still prohibits any action to recover possession. The landlord may seek relief from the automatic stay in order to obtain possession.

*Plan of Reorganization and Disclosure Statement*

The ultimate goal of a Chapter 11 proceeding is the formulation and confirmation of a plan of reorganization. In most cases, the debtor has the exclusive right to file a plan of reorganization during the first 90 days after the petition date and has an additional 30 days for soliciting acceptance of the plan by the creditors. Once this exclusivity period has passed, any interested party may file a plan. In many cases, in conjunction with the confirmation of the reorganization plan, the debtor will determine whether to assume or reject leases where it is a tenant. This strategy enables retailers and other tenants to assume some leases and reject others, depending on whether they have value to the debtor's business.

A plan is a contract between the debtor and its creditors concerning the treatment of obligations prior to confirmation of the plan. The bankruptcy code requires that the plan set forth adequate means for its implementation, such as selling assets, modifying contracts, restructuring operations or liquidating a portion of the operations.

*Chapter 7 Cases*
A Chapter 7 case consists of the liquidation of the debtor's assets (other than those exempt from creditors under applicable law) in exchange for a discharge of the debtor's pre-petition debts. In an asset case, the creditors will receive distributions according to the priority scheme set forth in the bankruptcy code. At the conclusion of the case, an individual debtor will receive a discharge of pre-petition debts but a corporation or partnership will not.

*Chapter 11 Cases*
In Chapter 11, a debtor tries to reorganize its debts by extending the time in which to pay them and reducing the total amount to be paid. Generally, a Chapter 11 debtor will remain in charge of the reorganization process and retain control over its business operations and management during the case. The bankruptcy code, however, provides the court with broad authority over the debtor's operations and allows creditors to monitor carefully the debtor's financial affairs to ensure that its assets are preserved for the benefit of all of the creditors.

*Involuntary Bankruptcy*
An involuntary case begins with the filing of a bankruptcy petition by three or more entities holding claims on the debtor that are not contingent as to liability and not subject to a *bona fide* dispute. If the debtor has fewer than 12 eligible holders of claims, an involuntary petition can be filed by just one qualifying creditor. If the debtor is a partnership, a subset of the general partners can initiate the involuntary filing. Petitioning creditors can be held liable for damages if the involuntary petition is determined to be wrongful or unwarranted, which potential liability serves as a deterrent to involuntary filings.

After the involuntary petition has been filed, but prior to entry of an order for relief, the debtor may continue to operate its business, acquiring and disposing of property without restriction. However, the court may limit the debtor's ability to dispose of assets of the estate if it believes that the debtor is acting in a manner detrimental to creditors. Despite there being no restrictions on the debtor's right to acquire or dispose of property, the automatic stay is still effective against the debtor's creditors.

An involuntary petition can result if the debtor is generally not paying its debts as they become due (unless such debts are subject to a *bona fide* dispute), or within 120 days of the filing a custodian, receiver or assignee took possession or charge of substantially all of the debtor's property. If the petitioning creditors can prove grounds for relief, the court will enter the order for relief and the case will proceed in the same manner as a voluntary case. The case may also be dismissed, provided that there is written notice to all creditors and then a hearing. An involuntary Chapter 7 petition may be converted by the debtor to a Chapter 11 petition.

*Options Other Than Bankruptcy*
There are scenarios outside of bankruptcy (not covered in detail here) that can arise involving financially troubled borrowers such as forbearance or workout agreements, foreclosure or deeds in *lieu* of foreclosure, state-court receivership actions or liquidation proceedings.

**Confirmation and Cram-Down — Lenders Beware!**
Classes of creditors vote to accept or reject a plan. If all impaired classes (creditors who will not be paid in full) approve the plan, it will be confirmed consensually. However, so long as even one impaired class votes to accept the plan, it may be

confirmed over the objection of other impaired classes through the "cram-down" provisions of the bankruptcy code. This concept is frequently employed in the case of a secured lender the value of whose collateral is less than the balance on its loan. In such a situation, the debtor can use the cram-down provisions to attempt to modify the interest rate or the term of the loan. If one class of impaired creditors votes in favor of the plan, and provided the other requirements of confirmation are satisfied, a plan that modifies the terms of an undersecured loan can be approved over the objection of the undersecured creditor. This tool is often used in connection with secured real estate loans where, for example, the property's primary tenant has vacated the premises or the property requires substantial renovations. By cram-down, the loan terms can be modified to reflect market conditions and the debtor's ability to pay.

If the court confirms the plan of reorganization, the debtor's pre-petition obligations are discharged and creditors are bound by the provisions of the plan, regardless of how they voted on it. Once the plan has been confirmed, the debtor is vested with all of the property of the estate and required to carry out the confirmed plan.

**Executory Contracts and Unexpired Leases**

An executory contract is defined as a contract, including a lease, under which the obligations of both parties are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other party. Upon the filing of a bankruptcy petition, the trustee or debtor-in-possession may either assume, assume and assign, or reject executory contracts.

Assumption of an executory contract or unexpired lease has two functions: the bankruptcy estate is obligated, as an expense of administration, to complete performance and the estate is entitled to the benefits of performance from the non-debtor party. In deciding whether to assume a contract, the trustee or debtor-in-possession should determine whether the cost of further performance by the debtor estate exceeds the benefit to be received from the non-debtor party. If the contract is profitable, the trustee or debtor-in-possession would be expected to assume the contract, thereby obtaining the non-debtor's contract performance in exchange for that of the debtor estate.

Rejection, on the other hand, is the estate's decision not to undertake further performance of the contract but to breach it. By rejecting the contract, the estate incurs liability for the breach in the form of a claim for contract damages, which claim is unsecured.

The non-debtor party cannot force the debtor to perform under the contract or lease prior to its assumption. In addition, the bankruptcy code requires a trustee or debtor to timely perform all the obligations of the debtor from and after the petition date under any unexpired lease until the lease is assumed or rejected. If the debtor fails to perform its obligations, a landlord or other creditor can file a motion to compel performance, including all payments due. Promptly seeking this relief can make a significant difference in the ultimate result for a creditor in a Chapter 11 proceeding, particularly when there is a question about the debtor's ultimate ability to reorganize.

Executory contracts and unexpired leases are deemed rejected if not assumed within 60 days of the petition date (although a court can extend this deadline and often does). Landlords should be mindful that during this pre-rejection period the debtor-tenant is required to comply with all current obligations under the lease. In the case of a deemed rejection, the real property should be immediately surrendered to the landlord. At any time, a landlord may file with the court a motion to compel the debtor to assume or reject the executory contract or unexpired lease.

In a Chapter 11 proceeding, the trustee or debtor-in-possession may assume or reject an executory contract at any time prior to confirmation unless, upon the request of a party to the contract or lease, the court orders that the trustee or debtor determine within a specified time whether to assume or reject the contract.

In a Chapter 7 case, the trustee has 60 days from the date of the bankruptcy filing (or of conversion from Chapter 11) to assume or reject an executory contract or unexpired lease. However, the court may extend this time for cause if a request is made within the initial period. If the trustee fails to assume the contract, it is deemed rejected.

In order to assume a lease or other executory contract, the trustee or debtor-in-possession must cure, or provide adequate assurance that it will promptly cure, any existing defaults, including those that existed on the petition date and provide adequate assurance of future performance under the lease.

A landlord should pay particular attention to notices regarding the assumption of leases. Generally, a debtor will file a motion to assume (or to assume and assign) a contract or lease, along with a proposal to cure any payment defaults. The landlord may then object to the motion. The parties will either resolve their dispute between themselves or a court will do so for them. Since the debtor will frequently propose a cure amount of zero, the landlord must object or it could waive any claim for additional amounts due.

A debtor may also assume a contract and then assign it to a third party, which invokes requirements for assumption.

The rejection of an executory contract constitutes a breach, which is deemed to occur immediately before the filing of the petition. Under the bankruptcy code, a landlord's claim for damages arising out of the termination of a lease for real property is limited to the "rent reserved by such lease," without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of the lease. In most cases, the landlord is entitled to a claim for one year's rent (plus additional rent, *etc.*) under the lease, plus any amount due as of the petition date.

A landlord's claim upon breach through rejection is reduced by the amount of any security deposit it holds. Depending on where the case is filed, the claim may also be reduced by the amount of a letter of credit provided in lieu of a security deposit. One federal appeals court recently ruled that a landlord's claim for damages upon the rejection would be reduced by the amount of a security deposit in the form of a letter of credit. Many jurisdictions have not definitively addressed this issue. The claim arising out of the rejection or breach of the lease is a general unsecured claim in the bankruptcy case.

While a trustee or debtor-in-possession may assume or reject an executory contract, it may not modify the contract without the agreement of the non-debtor party. Thus, the debtor must assume the entire contract, not just its favorable parts.

### *Important Considerations Upon a Tenant's Bankruptcy Filing*

An informed landlord will keep the following in mind when a tenant files for bankruptcy:

- The automatic stay will limit the landlord's remedies.
- If the lease terminated before the bankruptcy filing and the tenant remains as a holdover tenant, the landlord should consider seeking relief from the automatic stay to obtain possession.

- Under the bankruptcy code, all rent which accrues after the bankruptcy filing must be paid currently.
- Be mindful of the deadlines, particularly those to file a proof of claim and to assume or reject executory contracts.
- Do not apply a security deposit without advice of counsel.
- The debtor may assume or reject an executory contract, but modification of the lease requires agreement by the landlord.

***Protecting the Landlord If a Tenant May Be Filing for Bankruptcy Soon***

A landlord can take a number of steps to minimize its exposure before a tenant files for bankruptcy. The proper steps depend on the circumstances of each case, but the following are good overall guidelines:

- **Monitor Defaults.** This may include issuing timely notices of default in accordance with the lease and applicable state law. Also, the landlord should consider pursuing actions for possession early in the tenant's delinquency.
- **Payment and Application of Rents.** When a tenant is in financial trouble and bankruptcy is likely, if there are arrearages, it may be preferable for a landlord to apply payments to current rent due rather than to arrearages. Payments on current amounts due are less likely to be set aside as preferential transfers. Of course, state law may affect how the rent must be applied.
- **Obtaining Possession.** If the lease is terminated before the bankruptcy filing and the landlord obtains possession, the tenant likely will have no interest in the property upon the filing of bankruptcy. To that extent, the landlord will not be affected by the automatic stay.
- **Application of Security Deposit.** It can be advantageous for a landlord to exercise its rights with respect to a security deposit or letter of credit before the filing of a bankruptcy case, subject to the terms of the lease, the security deposit, the letter of credit and state law. Once a tenant files for bankruptcy, the landlord should not apply a security deposit without obtaining relief from the automatic stay.

If a tenant files for bankruptcy, a landlord cannot, without consent of the bankruptcy court:

- issue a default, demand or collection notice for rent that came due prior to the filing
- issue an invoice for rent due (including a year-end reconciliation that covers a pre-petition year, if there is a balance due)
- issue a notice of termination of a lease
- commence or continue a suit for possession
- commence or continue a suit for back rent
- apply a security deposit or draw down a letter of credit
- enforce a judgment for possession or for money.

Litigating contract disputes involving real estate matters in the US court system is often frustrating, confusing and complex. Lengthy delays in resolving cases, the high cost of litigation and unpredictable variations in the ultimate outcomes characterize the experience, and variations between various courts adds to the risks and uncertainties, particularly for those who do business on a regional, national or international basis. These negative impacts can be significantly compounded by the potential that an adverse party may be able to change the operative terms of the pertinent contract in the bankruptcy forum.

For all of these reasons, methods such as mediation and arbitration are increasingly popular for resolving real estate and other commercial contract disputes. At the same time, however, contracting parties need to have a shared understanding of the consequences of a default, which comes ultimately from a well-developed public body of pertinent case law. As a result, the real estate and business communities have a certain irreducible dependence on the state court litigation system, which uniquely serves to develop and make public the rules of law by which their transactions will proceed and their ventures will operate.

### Bankruptcy Glossary

**Absolute Priority Rule:** Rule prohibiting junior classes of claims from receiving a distribution in a Chapter 11 plan until all senior classes are paid in full.

**Adequate Assurance:** Standard that must be met prior to the assumption of an executory contract.

**Adequate Protection:** Protection that must be afforded to secured creditors in order to preserve their position at the petition date.

**Administrative Claim:** Any cost or expense of administration of the estate allowed under §503(b) of the Bankruptcy Code.

**Adversary Proceeding:** Any lawsuit filed in bankruptcy court, such as a complaint to determine the extent and validity of a lien, or an action to recover a voidable preference.

**Assumption:** To undertake an obligation. A debtor has the option to assume executory contracts (including leases) but must first cure any defaults.

**Automatic Stay:** Injunction, effective immediately upon the filing of a bankruptcy petition, that stays all litigation against the debtor and all efforts to collect debts.

**Bankruptcy Code:** Title 11 of the US Code.

**Bankruptcy Court:** A branch of the US District Court that is exclusively concerned with administering bankruptcy proceedings.

**Bankruptcy Estate:** All property, real or personal, in which the debtor has an interest at the commencement of a bankruptcy case.

**Bar Date:** The date designated by the bankruptcy court as the last date for filing a proof of claim or proof of interest against the debtor.

**Chapter 7:** The chapter of the Bankruptcy Code in which a trustee collects and liquidates a debtor's property, either voluntarily or by court order, to satisfy creditors.

**Chapter 11:** The chapter of the Bankruptcy Code in which an insolvent business, or one that is threatened with insolvency, attempts to reorganize itself under court supervision while continuing its normal operations and restructuring its debt.

**Chapter 11 Plan:** Procedure by which a business in a Chapter 11 bankruptcy case pays creditors and closes, either through reorganization or liquidation.

**Claim:** Any right to payment, whether or not is reduced to judgment.

**Confirmation:** Process by which a Chapter 11 plan obtains court approval.

**Cram-Down:** Court confirmation of a Chapter 11 plan despite the opposition of certain creditors. Typically occurs in the case of mortgage debt.

**Creditors Committee:** A committee comprising representatives of the creditors in a Chapter 11 proceeding. The Committee assists in the negotiation of the debtor's plan of reorganization.

**Cure:** The act of correcting all defaults.

**Debtor:** A person or entity who files a voluntary bankruptcy petition or against whom an involuntary bankruptcy petition is filed.

**Debtor-in-Possession:** A Chapter 11 debtor that continues to operate its business as a fiduciary to the bankruptcy estate.

**Discharge:** Court ordered release of liability for debts.

**Disclosure Statement:** Document that describes the term and effect of a Chapter 11 plan.

**Executory Contract:** Contract under which performance is due from both parties (bankrupt and non-bankrupt) at the time the petition is filed. Includes leases.

**Fraudulent Transfer:** Transfer of interest of the debtor in property, made within one year prior to the petition, made in order to delay or defraud creditors, or for which the debtor received less than a reasonably equivalent value, where the debtor was insolvent at the time of the transfer.

**Insolvent:** Financial condition where the sum of an entity's debts exceeds assets.

**Lift Stay Motion:** A motion filed with the bankruptcy court requesting that the automatic stay be modified.

**List of Creditors:** Required schedule giving the names and addresses of creditors, along with amounts owed them.

**Meeting of Creditors:** The first meeting of a debtor's creditors and equity security holders which is conducted shortly after the petition. The meeting is organized by the US trustee. At this meeting a bankruptcy trustee may be elected and the debtor may be examined under oath.

**Notice to Creditors:** A formal notice to creditors that a meeting of creditors will be held, that proofs of claim must be filed, or that an order for relief has been granted.

**Order for Relief:** Document that establishes a party's status as a debtor.

**Petition:** Document that begins a bankruptcy case, filed in a bankruptcy court (open 24 hours a day, 365 days a year).

**Preferential Transfer or Preference:** A transfer, recoverable by the trustee, made within 90 days of the bankruptcy petition by an insolvent debtor to or for the benefit of a creditor, thereby allowing the creditor to receive more than its proportionate share of the debtor's assets. Generally, a transfer that is not made in the ordinary course of business.

**Pre-Packaged Plan:** Chapter 11 that has been negotiated and accepted by creditors at the time of filing of the petition.

**Priority:** Scheme established by the bankruptcy code to determine the order for payment of claims.

**Proof of Claim:** A creditor's written statement that is filed with the bankruptcy court to show the basis and amount of the creditor's claim.

**Superiority:** The special priority status granted by the court to a creditor for extending credit to a debtor or trustee that cannot obtain unsecured credit from a willing lender.

**Trustee:** An officer of the court who is elected by creditors or appointed by a judge to act as the representative of a bankruptcy estate, and to administer the assets of estate.

**US Trustee:** A federal official who performs administrative tasks in the bankruptcy process.

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# Chapter 29

## FOREIGN INVESTMENT IN US REAL ESTATE: BANKRUPTCY ASPECTS

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### Introduction to US Bankruptcy Law

An investor in US real estate should understand the basics of US bankruptcy law, as the law affords the bankruptcy court broad powers to restructure the interests of creditors or to limit their claims. The need for such understanding is most obvious when an investor intends to purchase assets of a seller under bankruptcy court protection, though it may also arise in case of a bankruptcy of a foreign lender's borrower, an investor's tenant or the investor itself (or its US subsidiary).

While US bankruptcy law has counterparts in insolvency laws around the globe, several aspects distinguish it from other insolvency regimes. These include the possibility of the debtor restructuring and emerging from bankruptcy as a reorganized entity, the concept of a debtor-in-possession and the availability of debtor-in-possession financing.

First, US bankruptcy law offers the possibility of a debtor's reorganization and emergence as an entity absolved of its pre-petition liabilities. A debtor that seeks relief under Chapter 11 of the bankruptcy code is more likely to survive than one in certain foreign insolvency proceedings. The goal of Chapter 11 is not only to provide creditors with equitable distribution of the debtor's assets or value, but also to rehabilitate a financially viable business. Accordingly, a US debtor is given time to restructure while in Chapter 11 and to emerge as a reorganized entity.

Second, in contrast to regimes where an administrator or trustee is appointed to manage the business in insolvency, a Chapter 11 debtor's existing management typically continues to operate and manage the business during the pendency of the Chapter 11 proceeding. In such cases, the debtor is known as a "debtor-in-possession." As a debtor-in-possession, the company has all the rights otherwise available to a Chapter 11 trustee and must perform all of the duties and obligations of such a trustee.

Third, a market exists in the US for additional financing (called "DIP financing") for debtors in bankruptcy because the bankruptcy code provides special protection to lenders that provide post-petition loans. These lenders often are able to secure their loans with liens equal in priority, or even senior to, pre-petition liens on the debtor's assets. DIP financing is rare in single-asset real estate bankruptcies (described in greater detail later), but quite common in other business bankruptcies, such as those involving retail chains.

## US Bankruptcy Process

### Commencement of the Case and the Automatic Stay

The US bankruptcy code details the rights and obligations of debtors, creditors, equity holders and other parties upon the commencement of bankruptcy proceedings. While the code provides various forms of relief depending on the type of debtor and its financial situation, the two most common are liquidation (under Chapter 7) and reorganization (the usual course under Chapter 11, though it is possible to liquidate under Chapter 11). In most cases, a debtor will seek bankruptcy relief voluntarily, although in limited circumstances unsecured creditors have the ability to involuntarily commence a bankruptcy case against a debtor. Unlike many foreign insolvency regimes, a debtor need not be insolvent in order to file for bankruptcy protection, and it is not required to seek bankruptcy protection if it is insolvent. A solvent company, for example, would be within its rights to seek bankruptcy protection as a way of managing a sudden onslaught of litigation. Conversely, an insolvent company has the right to pursue a consensual restructuring with its creditors without the involvement of the bankruptcy court.

A bankruptcy case is commenced by the filing of a petition with the bankruptcy court. The filing (supplemented by other filings for relief) affords various benefits and protections to the debtor. The commencement of a bankruptcy case automatically creates an estate composed of all of the debtor's assets (wherever located and by whomever held), over which the bankruptcy court is vested with exclusive world wide jurisdiction. In other words, any interest the debtor holds in its assets, whether tangible or intangible, becomes a part of the bankruptcy estate and is directly subject to the jurisdiction of the bankruptcy court. The formation of the estate acts as a line of demarcation between the debtor's pre- and post-petition debts and obligations.

Moreover, subject to limited exceptions, the commencement of a bankruptcy case imposes an automatic stay prohibiting other parties from taking any action related to a pre-petition obligation of the debtor that may have any adverse effect on the debtor's estate. The automatic stay continues in effect for the duration of the bankruptcy proceedings unless lifted by the bankruptcy court either for cause (including a lack of adequate protection of a creditor's interest in property or if the debtor does not have equity in certain encumbered property and such property is not necessary to an effective reorganization). Actions taken in violation of the automatic stay generally are invalid, and the bankruptcy court may order relief to return to the estate unlawfully taken property and may impose sanctions on the violating party.

In the real estate context, the automatic stay prevents secured creditors, such as mortgagees and mezzanine lenders, from foreclosing on their security interests. It also prohibits lessors of real property from terminating unexpired leases and other parties from terminating contracts on the basis of a pre-petition breach, unless they obtain permission from the bankruptcy court. For instance, a lender's attempt to institute foreclosure proceedings or a landlord's attempt to terminate a lease and evict a bankrupt tenant will be treated as without legal effect as long as the automatic stay is in place. The automatic stay is supplemented by a separate prohibition on the enforcement of termination clauses in contracts or leases (contract provisions that provide for the *ipso facto* termination of a contract or lease either upon a bankruptcy filing or due to the insolvency or financial impairment of the debtor). Special provisions of the bankruptcy code apply to financing commitments and swaps and other derivative contracts.

**Chapter 7 *versus* Chapter 11**

As noted above, debtors most often seek relief under the bankruptcy code in the form of Chapter 7 liquidation or Chapter 11 reorganization. The primary goal in a Chapter 7 liquidation is to make distributions to the debtor's creditors through a quick sale (liquidation) of the debtor's assets. In all Chapter 7 cases, a trustee is appointed to administer the estate and supervise the orderly sale of estate assets and payment to creditors.

In most Chapter 11 cases, the debtor's primary goal is to reorganize its business so that it may emerge as a viable entity through a court-approved plan of reorganization which sets forth a scheme for distribution to creditors. As stated above, the bankruptcy code permits the debtor to remain in possession of its business and assets and to administer its own bankruptcy estate as a "debtor-in-possession,"[1] with all of the rights and duties of a Chapter 11 trustee. Because Chapter 11 reorganizations are far more common than Chapter 7 liquidations among significant commercial enterprises, the focus of this discussion will be Chapter 11 reorganizations.

**Debtors' Rights and Obligations**

***Asset Sales***

The protections afforded to a debtor by the automatic stay are balanced by certain restrictions on its freedom to use or sell its assets. The bankruptcy code requires the court's prior authorization for transactions involving the debtor's property outside the normal course of its business. A debtor's sale of fixed assets, such as real estate, could be considered a non-ordinary course transaction, unless the debtor's business involved the purchase and sale of real estate on a regular basis, as with a residential home or condominium builder. The debtor generally can sell assets free and clear of all liens, so long as any creditor with an interest in such assets is afforded "adequate protection," including a replacement lien in other property of the estate or a lien on the proceeds of the sale (described in greater detail below).

In the Chapter 11 context, the debtor's assets may be sold with the approval of the bankruptcy court. In an effort to solicit the "highest and best offer," as debtors are required to do when conducting an asset sale, debtors typically will engage in a marketing process among potentially interested parties in which it will solicit preliminary bids, and select an initial bidder (often referred to as a "stalking horse"). To ensure that the estate obtains the most value for the assets, bankruptcy courts generally will require that an auction for the assets be held. The stalking horse bidder, which likely will have expended considerable time and effort on the preparation of its initial bid, often will request, and be granted, protections within the bidding procedures to limit the harm it could suffer if the debtor ultimately receives and accepts a higher and better offer for the assets. Such bid protections typically include a break-up fee and expense reimbursement.

A secured creditor is entitled to "credit bid" its claim in a sale of assets over which it has a lien — to set off its claim against the purchase price of the assets. This effectively permits a secured creditor to ensure that a debtor does not sell its collateral below the amount of the secured creditor's claim, unless it consents to such a sale.

***Pre-Petition Contracts***

Parties to "executory contracts" with a debtor are not entitled to terminate these contracts

[1] The right of a debtor to become a debtor-in-possession is not absolute, and the bankruptcy court may appoint a trustee to administer the debtor's estate if cause is shown.

following the commencement of a bankruptcy proceeding.[2] The debtor may decide, subject to bankruptcy court approval, to assume or reject its executory contracts or unexpired leases.[3] To the extent that the debtor wishes to continue receiving the benefits of a pre-petition contract following its emergence from bankruptcy, it must assume the contract and perform under its terms after having cured any outstanding defaults. With the approval of the bankruptcy court, the debtor also has the right to assume and then assign to a third party an executory contract or unexpired lease. With certain limitations,[4] this right overrides any language in the contract or lease that expressly prohibits assignment or conditions assignment on consent of the other party to the contract. Conversely, a debtor may reject an executory contract or unexpired lease; the rejection will be deemed a pre-petition breach of the contract entitling the counterparty to a pre-petition claim for any damages arising from such breach.

***Post-Petition Contracts***

Debtors are permitted to enter into contracts after filing a bankruptcy petition and are bound to perform such contracts. Any payments due under post-petition contracts and any damages arising from breach of such contracts are afforded priority status as administrative expenses, ranking senior to the claims of all other unsecured creditors. Contracts assumed by the debtor in bankruptcy are treated like post-petition contracts, so that any damage claims arising after a petition likely will be afforded priority status.

***Avoidance Actions***

Debtors in Chapter 11 and trustees in Chapter 7 or 11 are granted powers to set aside certain pre-petition transactions that are found to be fraudulent conveyances or preferential transfers.

A fraudulent conveyance is a transfer of assets that has the effect of inappropriately moving assets beyond the reach of creditors. The bankruptcy code allows a debtor to pursue a fraudulent conveyance action under either the fraudulent conveyance provisions of the bankruptcy code or under other applicable state law. For instance, a debtor might sue a third-party transferee to recover a parcel of real property that it transferred to the third party in order to hide it from attachment by creditors. In some instances, an official committee representing the debtor's creditors or a liquidating trust formed pursuant to a confirmed plan of reorganization may bring such actions on behalf of their constituents.

A preferential transfer is a transfer of property by the debtor to a creditor within a specified period of time prior to the commencement of the bankruptcy case that enables such creditor to receive more than it would have received through a distribution in a Chapter 7 liquidation case. To bring an action to set aside a preferential transfer, the debtor or trustee must show that the transfer was made: (i) to or for the benefit of a creditor; (ii) for or on account of an antecedent debt; (iii) while the debtor was insolvent; and (iv) within 90 days prior to the commencement of the debtor's bankruptcy case if the transferee is not an "insider" or within one year prior to the commencement of the bankruptcy case if the creditor was an "insider."

A distressed entity might, for example, transfer assets to pay a creditor with which it has had a long-standing relationship in order to preserve the relationship. Because the goal of bankruptcy is to provide equitable treatment to all creditors, the preference provisions of the bankruptcy code

[2] The term "executory contract" generally refers to contracts under which performance obligations remain outstanding from both sides.

[3] Leases, in this context, are limited to true leases, not disguised financial arrangements.

[4] See, for example, the discussion of shopping center leases on page 223.

permit the debtor to seek to recover such transfers from the transferee.[5]

**Treatment of Claims**

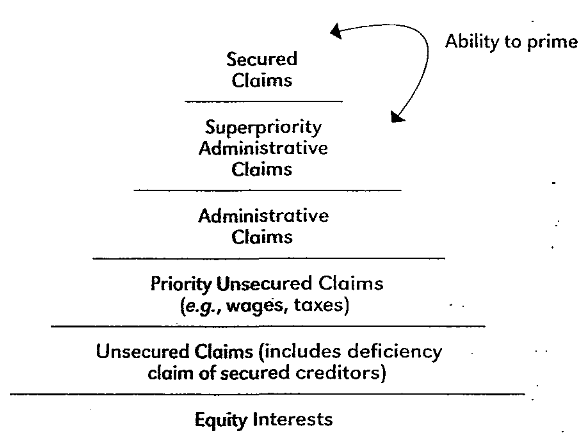
A core function of the bankruptcy process is to make a distribution of the debtor's assets for the benefit of creditors in whole or partial satisfaction of their pre-petition claims. The bankruptcy code establishes a hierarchy for the payment of claims based on their priority, with secured claims taking first priority and equity interests being satisfied after all other claims are paid in full. Generally, a plan of reorganization will not be confirmed by the bankruptcy court if it fails to provide that claims will be paid in accordance with the established hierarchy, illustrated in Exhibit 1.

The bankruptcy code defines a "claim" as a right to payment — whether or not reduced to judgment, liquidated, fixed, contingent, matured, disputed, legal, equitable or secured — or a right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not reduced to judgment, fixed, contingent, matured, disputed or secured.

Creditors holding liquidated, unliquidated, contingent or disputed claims against a debtor at the time the company files its Chapter 11 case hold "pre-petition" claims against the debtor. In contrast, "post-petition" creditors are those whose claims arise after the debtor commences its Chapter 11 case. In order to emerge from Chapter 11, a debtor must pay in full post-petition claims (which are referred to as administrative expenses and have priority over general unsecured claims). In a typical case, the debtor is not required to pay pre-petition claims in full, but rather, to emerge from bankruptcy it must pay creditors holding those claims at least as much as they would be paid if the debtor liquidated its business under Chapter 7.

Following the commencement of a bankruptcy case, the debtor is required to file a schedule of its assets and liabilities, after which a "bar date"

EXHIBIT 1




[5] As a general matter, the avoidance action provisions of the bankruptcy code (preferential transfers and fraudulent conveyances) do not apply to "safe harbored" financial contracts, such as derivative contracts.

will be set. The bar date is the date by which all claims must be filed by creditors. By filing a proof of claim, the creditors subject themselves to the jurisdiction of the bankruptcy court for the resolution of their claims. Once a proof of claim is filed, the debtor has an opportunity to object if it does not agree with the validity or the amount of the claim. The bankruptcy court will allow or disallow the claims and use a variety of methods to value them. The allowance process is essentially a trial within the bankruptcy case to determine the validity or extent of the purported claims. The bankruptcy court will estimate the probable value of claims that are unliquidated or contingent.

**Plan Process**

In order to emerge from Chapter 11, a debtor must obtain court approval ("confirmation") of a plan of reorganization, typically proposed by the debtor itself, though under limited circumstances other parties may submit plans of reorganization. The Chapter 11 plan will classify all claims against the debtor and set forth the treatment of such claims — most importantly, setting forth the amounts to be distributed to each class of creditors and the procedures for such distribution.[6] Creditors whose claims are "impaired" — those whose legal rights have been altered by the plan — will be permitted to vote on the plan and unimpaired creditors will be deemed to have accepted it. Creditors receiving no distribution under the plan will be deemed to have rejected it.

A plan not approved by all creditor classes may still be confirmed by the bankruptcy court through a procedure referred to as a "cram-down." To qualify for cram-down, at least one impaired class of creditors must have voted to accept the plan, it must not "discriminate unfairly" between the non-accepting classes and it must be "fair and equitable." A plan does not "discriminate unfairly" if it treats all similarly situated creditors or equity holders identically. The code sets out certain requirements for a plan to be considered "fair and equitable." In order to satisfy the fair and equitable standard with respect to a class of secured creditors that has voted against the plan, the plan must provide that those creditors either (x) retain their lien and receive deferred cash payments in an aggregate amount at least equal to the amount of their allowed claim and of a present value equal to the value of the allowed claim, or (y) receive the "indubitable equivalent" of their claim. Further, the plan must provide that each unsecured creditor that votes against the plan receives property of a value equal to the allowed amount of its claim or, if it does not, the claim must be paid in accordance with its "absolute priority," meaning no holder of a claim or interest junior to its class can receive or retain any value through the plan.

Once confirmed, all constituents are bound by the plan's terms. After a short appeal period, the plan becomes effective and a debtor's pre-petition debts are discharged if, under the plan, the debtor continues to engage in business. Debts incurred after the bankruptcy petition are considered administrative expenses of the estate and must be paid in full prior to the debtor's emergence from bankruptcy protection. Except as provided in the plan, bankruptcy discharge vests all property of the estate in the debtor, free and clear of all claims and interests, and enjoins any collection, recovery or offset of any pre-petition debt or claim against the reorganized debtor.[7]

## Single-Asset Real Estate Cases

Persons holding interests in or liens on real property should be aware of special provisions under the bankruptcy code that allow secured

6 The plan of reorganization must provide the same treatment for claims and interests that are substantially similar to each other. Therefore, substantially similar claims and interests are placed into the same "class" and all claims within a particular class receive the same treatment under the plan.

7 The bankruptcy court may not issue a discharge if the plan provides for the liquidation of all or substantially all of the property of the estate or the debtor does not engage in business after consummation of the plan.

creditors of single-asset real estate debtors to foreclose upon their security interests more easily than in other bankruptcy cases.

Generally, single-asset real estate cases involve a dispute between a borrower and its secured lenders. Typically, when a single-asset real estate borrower is unable to satisfy its mortgage obligations, the lenders commence foreclosure proceedings under applicable state law. To prevent a foreclosure sale and to obtain the protection of the bankruptcy code's automatic stay, the borrower may file for Chapter 11 protection before the foreclosure sale.

### Classification as "Single-Asset Real Estate" Debtor

The bankruptcy code lists three criteria for a debtor to constitute a "single-asset real estate" debtor. First, it must own real property that is a single property or project, other than residential real property with fewer than four residential units. Second, it must generate substantially all of its income from that real property. Third, it must not be involved in any substantial business other than the operation of that real property and its incidental activities. The test for independent substantial business activity is objective, meaning that the bankruptcy court looks to whether a reasonable and prudent business person would expect to generate substantial revenues from activities separate from the real estate operations.

### Impact of Classification as a Single-Asset Real Estate Debtor

In a single-asset real estate case, the restriction on foreclosing on the debtor's property during a bankruptcy proceeding is eased. In such a case, the bankruptcy court is required to grant a secured creditor relief from the automatic stay unless, within 90 days after the commencement of the bankruptcy case or 30 days after the bankruptcy court determines that the debtor is a single-asset real estate debtor, whichever is later, the debtor either files a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time or begins to make monthly payments to the secured creditor in an amount equal to interest at the current fair-market rate on the value of the secured creditor's interest in the real estate. The debtor may seek an extension of this 90-day grace period for cause.

With respect to the debtor's ability to make monthly payments to prevent a secured creditor from lifting the automatic stay, the debtor has the discretion to make monthly payments from rents or other income generated from the property and may do so without prior bankruptcy court approval or notice to the secured creditor, even if the creditor has a valid security interest in such rents or income. This allows the debtor to use such cash subject to a security interest (defined as "cash collateral" by the bankruptcy code) over the secured creditor's objection by demonstrating adequate protection of such security interest. A secured creditor may be unable to prevent a debtor from using the income generated from the property to make monthly payments, even if scheduled maintenance or improvement projects are delayed as a result. In such a case, the secured creditor may consider asserting a claim that its security interest in the real property is not being adequately protected, as the value of the collateral may be declining due to, among other things, the debtor's devoting insufficient financial resources to properly maintain the property.

## Sales

### Sales Free and Clear

As previously mentioned, a debtor can sell encumbered property either subject to or free and clear of any lien on it. In many circumstances, purchasers are unwilling to acquire property subject to a lien, and the debtor may seek bankruptcy court approval to sell the property free and clear of liens. In order for the debtor to obtain such approval, it must provide any secured creditor whose lien would be eliminated by the sale "adequate protection." Generally, this requirement is satisfied by allowing the lien to attach to the proceeds of the sale. Without adequate protection a secured creditor will be able to block the sale. As described above, a secured creditor is entitled to "credit bid" its claim in a sale of assets over which it has a lien. Further, in addition to the requirement of adequate protection for the secured creditor, the debtor will only obtain bankruptcy court approval to sell free and clear of a lien in one of five scenarios:

- applicable non-bankruptcy law permits the sale of property free and clear of the lien
- the secured creditor consents to the sale
- the price of the property to be sold is greater than the aggregate value of all the liens encumbering the property
- the lien was in *bona fide* dispute
- the secured creditor could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of the lien.

### *Interests of a Lessee in Real Property*

The debtor's ability to sell property free and clear of liens should not extend to leases to which the debtor's property is subject. If a debtor-lessor rejects an unexpired lease and the lessee retains rights under the lease, the lease should remain in full force and effect for the balance of its term (including any renewal or extension period) even after the sale of the property.

### *Environmental Liabilities*

A debtor's ability to sell its assets free and clear of environmental liabilities depends on the nature of those liabilities — specifically whether they are obligations to pay penalties or reimburse cleanup costs or obligations to comply with the terms of certain environmental regulations such as prohibitions on specified activities. Determination of whether property with environmental liabilities can be sold free and clear of liability relies heavily on the specific facts.

Obligations to pay penalties or to reimburse cleanup costs give rise to a claim for payment to environmental authorities. Many environmental statutes allow environmental authorities that hold such obligations against the debtor to become secured creditors by placing liens on the debtor's property. However, these liens do not cover future cleanup obligations and do not take priority over other existing liens. They must be recorded to be perfected and must be filed before the bankruptcy case is commenced. If these liens are recorded and perfected, the bankruptcy court could approve a sale of the debtor's property free and clear of environmental and other liens (in which event the authority's liens would attach to the sale proceeds), but the bankruptcy court cannot preclude any future environmental claims from being asserted against the purchaser.

Conversely, ongoing obligations to comply with environmental laws do not give the environmental authorities a right to payment. Because such obligations are not monetary in nature, they cannot be converted to liens upon the subject property. In such cases, the obligations remain with the subject property, and subsequent owners can be held liable for violations. Bankruptcy is not an excuse for the debtor or a subsequent owner to not comply with environmental laws.

## Transfer Taxes

Transfer or stamp taxes are imposed by many state and local jurisdictions on transfers of interests in real estate, including the mortgaging of real property. Such taxes are imposed only at the time of the transfer, in amounts typically determined in relation to the consideration or value of the property, and are imposed irrespective whether the transferor enjoyed a gain or suffered a loss on the transfer. The party responsible for paying the tax (seller or purchaser) varies by jurisdiction and can ordinarily be determined by agreement of the parties.

Under the bankruptcy code, transfers of real property pursuant to a confirmed plan of reorganization under Chapter 11 are exempt from state or local transfer taxes. Transfers of a debtor's real property in a sale conducted outside of a Chapter 11 plan, or prior to plan confirmation, are subject to state or local transfer taxes, including mortgage-recording taxes.

A purchaser responsible for all or a portion of the transfer tax may wish to stipulate a sale pursuant to a confirmed Chapter 11 plan in order to avoid the tax. However, the risk of future depreciation or the cost of maintaining the property prior to sale may persuade the parties to consummate a sale prior to plan confirmation, thereby forcing the parties to incur potentially significant transfer taxes.

## Real Estate-Related Aspects of Chapter 11

### Debtor as Borrower

Over the past several years, real estate-secured loans have been made to special-purpose vehicles (SPVs) — newly established entities created to hold title to the real estate collateral, often in the form of a single-member limited liability company wholly owned by the loan applicant. This structure, which resulted from lessons learned by lenders in the significant downturn of the early 1990s, is designed to limit the number of claimants and the amount of claims against the collateral and its owner, as well as the opportunities for the borrower to voluntarily file under Chapter 11. For these reasons, the borrower SPV will typically covenant to hold no assets other than the loan collateral, to engage in no unrelated business, and not to declare bankruptcy without approval of one or more independent members or directors appointed with the approval of the lender.

The efficacy of these covenants has not been fully established but, at least outside the bankruptcy context, they have rendered less meaningful the distinction between recourse and non-recourse debt. When the borrower SPV is permitted to have no assets other than the loan collateral, the lender has no meaningful deficiency claim against it. Yet, lenders have remained concerned about the possibility that, whether through action or neglect, the collateral may be impaired. Thus, lenders typically require a "bad-boy" guaranty, pursuant to which a party other than the borrower becomes responsible for repayment of the loan or for damages suffered if the collateral value is impaired through misappropriation of funds, neglect or other specified occurrences.

Despite these developments, there remains the possibility that a borrower will file for bankruptcy. Thus, it is important to understand the basic principles as applied to secured and undersecured creditors.

As previously discussed, the bankruptcy code permits a debtor to grant, in favor of "DIP" lenders (those providing additional financing to a debtor during bankruptcy), a lien that is senior, equal or junior in priority to any lien granted to its pre-petition secured creditors. As such a step may significantly affect a secured creditor's interest in its collateral, the debtor cannot take it without first providing "adequate protection" to the affected pre-petition secured creditor and obtaining bankruptcy court approval.

Moreover, in the Chapter 11 case commenced by General Growth Properties, a number of its SPV subsidiaries also filed voluntary Chapter 11 proceedings. GGP is one of the largest owners/operators of shopping centers in the United States. It was also one of the most significant borrowers in the commercial mortgage backed securities market — with aggregate debt in excess of $27 billion. GGP owned many of its shopping center properties through CMBS approved SPV structures. GGP's decision to file the SPVs was and continues to be controversial because many of the SPVs were cash flow positive, with significant net worth. Even more surprising (and controversial) was GGP's request (and the bankruptcy court's approval) to use the SPVs excess cash flow to fund its global Chapter 11 process, in addition to its approved $375 million debtor-in-possession credit facility. This excess cash was otherwise the SPV lender's cash collateral. Although the bankruptcy court granted the SPV lenders extraordinary adequate protection rights, many viewed the court's ruling as a departure from the perceived separateness of the SPV structure and potentially disruptive to the future of the commercial real estate lending market.

Unsecured lenders are entitled only to make a pre-petition claim against the debtor for sums owed, which will be treated as unsecured and subordinate to all secured, administrative and priority claims. If paid at all, an unsecured creditor will often receive only a fraction of its allowed claim. By contrast, lenders who have a valid perfected security interest in the debtor's property receive many forms of protection. In most Chapter 11 cases, secured creditors will retain their liens on the collateral (or substitute collateral) upon the debtor's emergence from bankruptcy, or else will be paid the entire value of their collateralized claim if the collateral is sold during the bankruptcy. Additionally, the bankruptcy code provides secured creditors certain advantages unavailable to other parties. For instance, in contrast to unsecured creditors who are not entitled to interest that accrues after the petition date, secured creditors are entitled to post-petition interest to the extent that the value of the collateral securing the claim exceeds the value of the creditor's allowed claim, though they may not be able to receive actual interest payments until after the plan of reorganization is confirmed. A secured creditor also is entitled to "credit bid" its claim in a sale of assets over which it has a lien.

The bankruptcy code also provides certain advantages to undersecured creditors (those whose allowed claim exceeds the value of the collateral securing the claims), especially non-recourse secured creditors. Outside of bankruptcy, a non-recourse secured lender will be limited to the value of the collateral upon which it forecloses and would not be able to seek a judgment against the borrower for any deficiency. However, the bankruptcy code ordinarily treats non-recourse secured creditors as if they had recourse against the debtor on account of their claim. The claim is divided into a secured claim up to the value of the collateral and an unsecured claim for any deficiency. The unsecured deficiency claim will be given the same treatment as all other unsecured claims (and likely will be paid a fraction of its value). This treatment is unavailable to non-recourse secured creditors whose collateral is to be sold in the bankruptcy process or where the class of non-recourse secured creditors elects a certain different treatment (discussed below).

Regardless whether a secured creditor has recourse against the debtor outside of bankruptcy, the bankruptcy code allows a class of undersecured creditors to elect to be treated as fully secured up to the allowed amount of their claims.[8] In a class that elects this treatment, an undersecured creditor waives its deficiency claim, betting in essence that the debtor will be able to continue to make payments after its emergence from bankruptcy and, in case the debtor later defaults on its payments and the creditor forecloses on the collateral, that the value of the collateral will have increased. If the value of the collateral increases sufficiently, the creditor will be able to realize the full value of its outstanding loan upon foreclosure. If the value of the collateral remains the same or decreases, the creditor will again have a deficiency which, if non-recourse, it will be unable to pursue. Before making this election, an undersecured creditor must carefully assess the likelihood of recovery under each scenario. If the creditor expects the value of the collateral to significantly

[8] This is referred to as an "1111(b)" election because it derives from Section 1111(b) of the bankruptcy code.

increase over time, it is likely to receive a greater recovery by electing fully-secured treatment. If it expects the value of the collateral to remain the same or decrease, the creditor might be better off asserting an unsecured deficiency claim and receiving whatever payout is available during the bankruptcy. An undersecured creditor may not elect 1111(b) treatment if the underlying collateral is to be sold during the course of the bankruptcy or if its lien is of inconsequential value.

### Lease Issues — Assumption, Assignment, Rejection, *etc.*

#### *Debtor as Lessee — Time Period for Assumption or Rejection*

A debtor has 120 days after the commencement of the bankruptcy proceeding to assume or reject unexpired non-residential real property leases. The bankruptcy court may extend this period only for cause for an additional 90 days. Any further extensions are granted on a lease-by-lease basis with prior written consent of each lessor. This time constraint requires a debtor to quickly analyze its operations and develop a business plan for reorganization, but often results in numerous lease rejections when the debtor cannot develop such a plan within the 210-day period.

For residential real property leases, the debtor has more leeway and may assume or reject unexpired leases at any time prior to the confirmation of the reorganization plan. At the request of any party to such a lease, the bankruptcy court may, however, order the debtor to assume or reject the lease before the debtor has indicated its willingness to do so.

#### *Debtor as Lessee — Special Provisions on Curing Non-Monetary Defaults*

In order to assume an executory contract or unexpired lease, the debtor must cure certain defaults, compensate the counterparty for any actual pecuniary loss resulting from the default and provide adequate assurance of future performance. However, the debtor is not required to cure any non-monetary defaults under a lease of real property if it is impossible for the debtor to cure the default at and after the time of assumption. For instance, commercial leases often contain "going dark" clauses, which require the lessee to continuously operate its business at that location or be in breach of the lease. In many bankruptcy cases, the debtor already has shut down operations so that, by the time it decides to assume its lease, it is already in breach because of its failure to maintain a continuous operation. In such a case, it would be impossible for the debtor to cure the default; it could not go back in time to continually operate its business. The bankruptcy code treats such a non-monetary default as being cured by performance in accordance with the lease terms at and after the time of assumption. In other words, it is sufficient that the debtor will restart its operations on the leased property at the time of assumption and will continue such operations thereafter. Nevertheless, the requirement of future performance can still be problematic in cases where the debtor wishes to assign its lease to a third party, but the third party will be unable to continually operate the premises because of required renovations.

#### *Debtor as Lessee — Shopping Center Lease Provisions*

Generally, a debtor only needs to provide adequate assurance to obtain the bankruptcy court's permission to assume and assign a lease. The bankruptcy code imposes additional restrictions on assumptions and assignments of shopping center leases, however, enumerating specific requirements for adequate assurance of future performance for shopping center lease assignees, namely that the percentage of rent will not decline substantially; the tenant will be subject to the lease's provisions, including those regarding radius, location, use or exclusivity; and the shopping center's tenant mix or balance will not be disrupted. Ideally, the result of these restrictions is that the assignee tenant will be one engaged in a substantially similar business with substantially similar revenue streams to those of the once-solvent debtor.

*Debtor as Lessor*

Where the debtor is a lessor of real property and chooses to reject an unexpired lease, the lessee has the option of either terminating the lease or retaining its rights under the lease. If a rejection amounts to a breach that would allow the lessee to treat the lease as terminated by virtue of its terms, applicable non-bankruptcy law (*e.g.*, state law) or any other agreements, then the lessee may treat the lease as terminated by the rejection. The termination would be deemed to be effective immediately prior to the commencement of the bankruptcy case and the lessee would hold a pre-petition claim for any damages resulting from the termination. Alternatively, the lessee may retain the rights under the lease that are in or appurtenant to the real property for the balance of the lease term and for any renewal or extension, all to the extent that they otherwise are enforceable. These rights include, but are not limited to, the right to sublet, assign or hypothecate the lease and to use and possess the premises. The lessee can thus remain on the subject property despite any sale of the leased property to a third party.

### Claims Issues

*General Treatment of Letters of Credit*

A standby letter of credit is a commercial instrument that obligates the issuer to pay the beneficiary upon presentation of agreed documentation. The issuer's obligation under the letter of credit is treated as independent of the underlying contract between the beneficiary of the letter of credit and the customer. Accordingly, if the customer files for bankruptcy, neither the letter of credit nor its proceeds are property of the customer's bankruptcy estate. Thus, the beneficiary's right to draw upon the letter of credit is not subject to the automatic stay, even though the effect of the withdrawal will be a claim against the debtor customer by the letter of credit issuer.

*Unpaid Rent*

The treatment of unpaid rent depends on whether the debtor chooses to assume or reject the unexpired lease. In order to assume an unexpired lease, a debtor first must pay any existing unpaid rent. If the debtor chooses to reject the unexpired lease, the rejection is treated as a breach of the lease immediately prior to the commencement of the bankruptcy case. Thus, the counterparty to the rejected lease would hold a pre-petition claim in the amount of unpaid rent and any other damages.

***Special Provisions Regarding Lease Termination Damages***

*Claims of a Lessor Against a Debtor-Lessee: Statutory Cap on Pre-Petition Damages — General Application*

Under the bankruptcy code, a lessor's claim for damages against a debtor-lessee resulting from termination of a lease of real estate is limited to the rent reserved by the lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease following the earlier of the commencement of the bankruptcy case or the date on which the lessor repossessed or the debtor lessee surrendered the property (this is commonly referred to as a "502(b)(6) cap," referring to the section of the bankruptcy code that limits the landlord's claim). The majority of bankruptcy courts finds that "15 percent" refers to 15 percent of the total rent due under the remainder of the lease, while a minority finds that it refers to 15 percent of the time remaining through the natural end of the lease. Any unpaid rent due prior to the commencement of the bankruptcy case or the repossession or surrender (whichever is earlier) will not be subject to this statutory limitation.

In many US jurisdictions, damages for termination of a lease of residential real property are limited by statute. Any claim against a debtor for damages will thus be limited by applicable non-bankruptcy law.

*Claims of a Lessor Against a Debtor-Lessee: Statutory Cap on Pre-Petition Damages — Guaranty Issues*

The statutory cap on real estate lease-termination damages is intended to compensate the lessor fairly while limiting its claim for damages from consuming the debtor's entire estate at the expense of other creditors. This cap also limits both debtor-guarantors' and third-party guarantors' rights of reimbursement or contribution, but does not limit a lessor's claim against a non-bankrupt lease guarantor.

While the bankruptcy code is silent as to the applicability of the statutory cap, bankruptcy courts consistently have held that the statutory cap applies whether the debtor is the lessee or the guarantor. In situations where the tenant and the guarantor are both debtors, at least one court has determined that the landlord should have a single 502(b)(6) claim against the estates. This also should be the case where two affiliated debtors are co-tenants under a lease.

Similarly, a third-party guarantor's right of reimbursement or contribution against a debtor is statutorily capped. The bankruptcy code disallows any claim of reimbursement where the entity seeking reimbursement is liable with the debtor and the underlying creditor's claim against the debtor's estate is or would be disallowed. Since a guarantor is liable with the debtor and the creditor-lessor's claim is statutorily capped, a guarantor of the lease may only seek reimbursement from the debtor up to the statutory cap.

*Claims of a Lessor Against a Debtor-Lessee: Statutory Cap on Pre-Petition Damages — Security Deposit Issues*

Generally, a cash security deposit by a lessee is treated as part of the bankruptcy estate. Thus, any amount in excess of the lessor's allowed claim is refundable to the estate. If a lessee posts a security deposit in the form of a letter of credit in favor of the lessor and breaches its lease, the lessor is not restricted from drawing upon the letter of credit, nor does the bankruptcy court have the authority to prevent the lessor from doing so. However, any amounts that the lessor draws from the letter of credit will be applied to any claim by the lessor for damage resulting from the breach of the lease. As these claims are statutorily capped, the lessor's claim against the debtor for lease termination damages will be reduced by any amount drawn by the lessor from the letter of credit, but the lessor will not be liable for any amounts it drew from the letter of credit in excess of the statutorily capped damage claim. A creditor lessor may thus draw down in full on a letter of credit, but if the amount drawn down equals or exceeds the creditor's allowed termination damages under the statutory cap the creditor lessor may not also assert a claim for termination damages against the estate. Conversely, if the draw down is less than the allowed damages under the statutory cap, then the creditor may assert a claim for termination damages against the estate in the amount of the deficiency.

Lessees often choose the letter of credit alternative because of the availability of credit facilities and a potentially smaller cash outlay and lessors often permit lessees to choose the form in which a security deposit is posted. From the foregoing analysis, one would conclude that a lessor would benefit from a letter of credit and should consider requiring them (subject to credit considerations). Lessees, by contrast, should be indifferent to using a letter of credit or cash as a security deposit (subject to any costs of posting the letter of credit). Just as the lessor's claim for termination damages is capped under the bankruptcy code, the letter of credit issuer's claim against the debtor upon the lessor's draw-down of the letter of credit may be capped as well.

*Claims of a Lessor Against a Debtor-Lessee: Statutory Cap on Administrative Expense Claims*
If a debtor lessee assumes a lease in bankruptcy and subsequently rejects the lease or defaults under the lease, any arising damages constitute an administrative expense and are not subject to the bankruptcy code's statutory cap. These damages are subject to certain limitations in that they are limited to the obligations under the lease for the two-year period following the later of the rejection date and the date of repossession and they may not include any amounts arising under the lease relating either to a failure to operate or any penalty amounts. However, these damages are not subject to reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, such as a new tenant.

*Claims of a Lessee Against a Debtor-Lessor*
If a debtor-lessor rejects an unexpired lease of real property and the lessee retains rights under the lease, as discussed above, the lessee may offset against rent the value of any damage caused by the debtor-lessor's nonperformance after the date of rejection of any of the debtor-lessor's obligations under the lease. The lessee may only offset its rent, however, it does not have any other right to assert a claim against the debtor-lessor for its nonperformance.

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# Chapter 30

# RESTRUCTURING AND WORKOUTS OF REAL ESTATE LOANS

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## If a Loan Goes into Default

### First Steps

Lenders should have systems in place to identify early indications, such as late payments and late reporting, that a loan is in distress. Care should be taken in examining borrower reports to track increasing loan-to-value (LTV) ratios or lower debt service coverage ratios (DSCRs). Once a loan goes into a default, the first thing a lender should do is make sure that the loan file is complete, all documents were signed, mortgages and assignment of leases and rents recorded, UCC financing statements filed and extended, and title policies issued. The lender or its counsel will need to get a complete picture of the loan and the documents (including any amendments) and should review correspondence and e-mail files to check for agreements, dealings or conduct between the parties that might affect the interpretation of the loan documents. The loan documents should be carefully checked in light of the occurrence of the default, and the lender's rights and remedies assessed. In multi-lender deals, the authority of the agent and or servicer to act on behalf of the syndicate with respect to the default, a possible restructuring or exercise of remedies will need to be determined, taking into consideration any consent or consulting rights of syndicate, mezzanine or second-lien lenders. When sending the default notice to the borrower, a lender should take care to observe the notice provisions of the loan documents. The default notice should be clear and unambiguous and should reserve the right to exercise all rights and remedies under the loan documents. If the loan documents permit charging default interest (or a late payment charge), the notice should state that such rate is now applicable or that the lender reserves the right to charge default interest. Depending on the lender's assessment of the severity of the problem, if the loan has a springing or soft lockbox and the documents permit it, steps should be taken to implement or lock down the lockbox.

### Negotiating with the Borrower

Unless the lender has lost faith in the borrower's ability to operate and manage the property, the lender will likely be open to negotiating a solution to the problem that caused the default. The lender should condition its participation in such discussions with the borrower on the execution of a pre-negotiation agreement by all involved parties. Such an agreement would specify that the discussions are not binding unless and until any agreement reached is memorialized in a signed agreement, that no party has any obligation to enter into an agreement, that the content of the discussions will not be admissible in court, and that all attorneys' fees and expenses incurred by the lender in connection with the negotiations are borne by the borrower and guarantor. Such an agreement will usually contain an acknowledgement by the borrower parties that the loan documents are enforceable and remain in full force and effect. Some lenders will not enter into negotiations unless the borrower agrees to waive any claims it might otherwise want to assert. If there are multiple lenders involved, they should agree on a common position before communicating with the borrower. To promote information sharing among the lenders and their counsel, and to protect communications between them, the lenders will want to enter into a common interest sharing agreement.

**Working Out the Loan**

The toolkit for working out or restructuring a loan is extensive. If the default was caused by a loan-to-value or similar covenant breach but the loan is otherwise current, the lender may be willing to temporarily waive or relax the covenant by granting a written waiver or requesting partial pay-down of the principal balance to bring the loan back into compliance. A lender will likely want to charge a fee in consideration for its willingness to waive such a default. If the default is a maturity default caused by a failure to refinance or sell the property at a price sufficient to repay the debt, the lender may be willing to extend the loan. Such a waiver or extension could be documented by a simple amendment.

An alternative to a waiver of the default is to enter into a forbearance agreement, which would acknowledge the existence of the default and set forth the terms on which the lender is willing to forbear exercising its rights and remedies with respect to the default. The forbearance agreement could also spell out additional lender's rights and remedies in the event the borrower fails to comply with its terms. A lender might even require the borrower to deliver the deed to the property to a title company to be held in escrow until an event of default under the forbearance agreement occurs, at which time the deed would be released to the lender. However, deeds in escrow may not always be effective.

In the event a lender is willing to forgive or release a portion of the debt, the borrower will need to be mindful of the tax consequences (such as phantom income from the cancellation of debt). If the property is highly leveraged, the equity as well as the junior debt tranches might be underwater both in terms of collateral value and sufficiency of cash flow for debt service. In such a scenario, neither the equity holder nor the junior lenders might be willing to put additional equity into the deal to avoid throwing good money after bad. The equity holder might determine to hand over the keys to the lenders and a mezzanine lender might decide to walk rather than fight. Despite the inability or unwillingness of an equity owner or mezzanine lender to put additional money into the deal and despite an equity owner or mezzanine lender being completely under water, the mortgage lender might still permit the equity owner or a mezzanine lender to stay in the deal. This could occur where the alternative of foreclosure is not attractive: if there is no buyer, the lender will end up owning the property and will have to confront the same challenges that the existing owner faced (albeit with the added benefit of having wiped out the existing equity, mezzanine debt and any junior liens). If the lender determines that it is unlikely to do a better job running the property than the prior owner, or accounting, tax, environmental, liability or other concerns might make property ownership less appealing, restructuring the loan might be more attractive than foreclosing (where the lender expects that it would end up owning the property) or accepting a deed in lieu of foreclosure.

## When the Workout Fails

If the lender(s) and borrower cannot agree on the terms of a restructuring, or the lender has lost faith in the borrower's ability to successfully operate the property, or there simply is not enough value to be restructured, the lender usually has three basic remedies:

- It can accelerate the indebtedness and initiate judicial foreclosure proceedings.
- It can accelerate the indebtedness and sell, or cause a trustee to sell, the property pursuant to a power of sale granted in the security instrument (to the extent such right is granted and available under applicable state laws).
- It can accelerate the indebtedness and accept a deed in *lieu* of foreclosure from the borrower if the borrower is willing to entertain this option.

In contrast to judicial foreclosure proceedings, which are typically time consuming and costly, non-judicial foreclosures or trustee sales are usually swift and inexpensive. Accepting a deed in *lieu* of foreclosure will save time and cost but does not eliminate subordinate liens. Also, acceptance will extinguish the entire debt regardless of the property value, eliminating any deficiency claim. During the run-up to a judicial or non-judicial foreclosure, the lender might want to seek the appointment of a receiver of the property to protect the rents and other cash flow and to avoid "mortgagee-in-possession" and other lender-liability issues (discussed later). Appointment of a receiver comes with a cost, usually borne by the lender either directly or indirectly. In states with a "One Action Rule," a lender should be careful not to sue under the note or a guaranty, which will preclude it from later initiating a foreclosure action.

### Real Estate Owned Property (REO Property)

If the bids submitted at a judicial or non-judicial foreclosure sale of the property come in lower than the mortgage debt and the lender is unwilling to accept a discounted payoff, the lender will usually bid in all or a portion of its debt to acquire the property (credit bid). The amount of the credit bid should approximate the value of the property (minus a foreclosure discount), and the debt would be cancelled in an amount equal to the bid amount. Title to the property would usually be held in a special-purpose company owned by the agent and or the lenders in proportion to the amounts of their debt. Property taken by a lender in (partial) satisfaction of the debt is commonly referred to as real estate owned property (REO property). As lenders are not typically in the business of owning real properties, such a step may raise a number of legal, accounting and tax issues.

### Suing the Borrower and or Guarantor

If the proceeds from a judicial or non-judicial foreclosure sale of the property are not sufficient to repay the lender in full, the lender has to decide how to proceed with respect to the remaining deficiency. As most commercial mortgage loans are structured as non-recourse loans, meaning that the lender has recourse to the borrower only to the extent of the borrower's interest in the property (and not to any other assets of the borrower), suing the borrower will not be an option. If all or part of the loan is guaranteed by the borrower's equity owners, a lender will sue the guarantor for the deficiency up to the guaranteed amount (if the lender believes the guarantor has assets to satisfy the guaranty claim). Most loans do not have the benefit of a payment guaranty and the lender's only recourse to a guarantor is the so-called "bad-boy" or "non-recourse carve-out" guaranty. These are guaranties pursuant to which the guarantor has agreed to pay any damages resulting from certain prohibited borrower acts, such as waste, fraud or failure to pay real estate taxes or insurance premiums. If the borrower has committed one of these acts, the lender can sue the guarantor for any resulting damages (and in some cases even for the entire debt), but such a claim may be difficult to prove. Some bad-boy guaranties are triggered by a borrower's bankruptcy filing. In such situations, the guaranty is intended to give the lender recourse to the guarantor for the entire mortgage debt.

### Typical Borrower Defenses

A borrower with its back against the wall and about to lose its property investment may resort to a variety of tactics to avert or delay the lender's exercise of remedies. Sometimes a borrower's resistance may be driven by tax considerations (avoidance of phantom income as a result of gain recognition and depreciation recapture upon foreclosure of a non-recourse loan). A borrower might assert that the lender promised to extend a loan, provide refinancing or waive a default, and that it relied on the lender's promises and, as a result, did not seek alternative financing options or solicit buyers. It might also assert defenses based on any number of legal theories, such as an oral agreement to waive, modify or forbear, fraud, misrepresentation, tortious interference with the borrower's business relationships, negligence, breach of implied covenant of good faith and fair dealing, breach of fiduciary duty, economic duress, unconscionability, overreaching, unequal bargaining position, estoppel, detrimental reliance and others.

### Sources of Lender Liability

Allegations of lender misconduct and liability are often plentiful in distressed-loan situations but rarely stick. Sources of lender liability include:

- unwillingness to fund or make required advances
- threatening actions with no intention to follow through in order to induce action by the borrower
- interference with a borrower's contractual relationship with a third party, such as a tenant
- violation of servicing standards or duty of care *vis á vis* syndicate lenders
- failure to act in good faith or deal fairly with the borrower or inconsistency in the performance and enforcement of the loan documents
- breach of fiduciary duty where a lender has taken on the role of a business advisor to the borrower
- direct liability as a principal where a lender holds itself out to third parties as controlling the borrower
- control, where the lender gets involved in day-to-day business decisions of the borrower
- environmental liability, where the lender acts as an owner, operator or asset manager under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)
- economic duress, where the lender conditions its compliance with existing funding obligations on additional consideration
- aiding and abetting a borrower's fraud *vis á vis* third parties, where the lender knows the borrower is committing fraud but stays silent
- failure to use due care after foreclosing on a property and finishing construction
- mortgagee-in-possession claims.

## "Tranche Warfare"

One of the challenges facing lenders and borrowers is to accommodate the often-diverging interests of senior and junior lenders and to understand their respective rights in highly-structured deals. A highly-leveraged deal might consist of a senior mortgage loan and one or more mezzanine loans. The mortgage and mezzanine loans might in turn be sliced into senior and one or more junior pieces (in an "A/B structure"). An A/B structure might take the form of senior and junior lenders holding their own notes issued by the borrower, or it might take the form of a loan participation in which one lender holds the note and participates (senior and junior) interests to investors. All or a portion of the mortgage loan might be securitized (as commercial mortgage-backed securities, or CMBS). In a mortgage loan with an A/B-note structure, all lenders have the same borrower and the same collateral (the mortgaged property) but they agree contractually on a payment waterfall that creates two or more levels of seniority among the lenders. A typical A/B co-lender agreement will provide that, following an event of default (or another triggering event), all proceeds from the collateral will be used to repay the A-note until it is reduced to zero before any payments are made on the B-note. The agreement will often provide also that the B-note holder will initially control workout discussions with the borrower (on the theory that the B-note holder will suffer the first loss from a deterioration of the collateral and will therefore be most incentivized to maximize value in a workout). The B-note holder will lose these control rights, however, if — stated simply — the value of the collateral (less the outstanding principal balance of the A-note) covers less than 25 percent of its outstanding principal balance. Emergence of such a condition is known as a "control-appraisal event." Sometimes the B-note holder has the right to retain its rights as the controlling holder by putting up collateral in an amount which, when added to the value of the property, will keep its stake at or above the 25 percent threshold and avert a control-appraisal event.

The interests of the A-note and B-note holders will not always be aligned. While the former might prefer a liquidation of the collateral if the proceeds will be sufficient to repay its debt in full (or at a rate it finds acceptable), the latter will oppose liquidation when the proceeds remaining after repayment on the A-note will be insufficient to cover its debt. In such cases, rifts may occur among the lenders, sometimes leading to impasse and threatening the success of a workout. Although occasionally a junior lender will be secured by a second mortgage on the property, second lien-loans have become rare and largely have been replaced by mezzanine loans.

Unlike a mortgage loan, a mezzanine loan is not directly secured by the real estate: the mortgage and mezzanine lenders have different borrowers and different collateral. The mortgage loan is made to the owner of the property (the mortgage borrower) and is secured by a mortgage on the property. The mezzanine loan is made to the parent company of the mortgage borrower (the mezzanine borrower) and is secured by the mezzanine borrower's ownership interest in the mortgage borrower. In the case of multiple layers of mezzanine debt, the first mezzanine lender would make its loan to the parent of the mortgage borrower and the second mezzanine lender would make its loan to the parent of the first mezzanine borrower. The first mezzanine lender's collateral would be a pledge of the first mezzanine borrower's ownership interest in the mortgage borrower, and the second mezzanine lender's collateral would be a pledge of the second mezzanine borrower's ownership interest in the first mezzanine borrower.

An inter-creditor agreement governs the relationship between mortgage and mezzanine lenders and will restrict the lenders' ability to modify the terms of their loans without the other lenders' consent (which restrictions are often relaxed for a lender whose loan has defaulted). While a default under the mortgage loan or more senior mezzanine loans will also constitute a default under a junior mezzanine loan, a default under a junior mezzanine loan will not, in and of itself, trigger a default under the more senior mezzanine loans or the mortgage loan. If a default occurs anywhere in the structure, the most junior lender has the first right to cure such default, provided that it also cures all other defaults in any loan senior to it. If the most junior lender is not willing to cure, the right to cure passes to the next junior lender, and so forth. So long as all loans senior to a mezzanine lender are cured, such mezzanine lender can foreclose on its separate collateral without interference from the other lenders. In the event a mezzanine lender forecloses on its collateral and replaces its borrower as the holder of the equity interest in the holding structure, the original sponsors of the property, as well as all lenders junior to the foreclosing mezzanine lender, are cut off from the property.

Mezzanine loan foreclosures are usually conducted in a public sale in accordance with Article 9 of the applicable Uniform Commercial Code. Unlike judicial real estate foreclosures, UCC foreclosures are fast and relatively inexpensive. Since they do not involve real property, a lender does not have to deal with any statutory rights of redemption that state real estate laws might grant a mortgage borrower (rights that would permit a borrower to obtain a release of its property, even after a foreclosure sale, if it tenders the full amount of the debt within a certain period of time). These advantages mean that the ultimate owner of the real property might find itself divested of its equity in the property much faster when there is a mezzanine loan in the structure that goes into default. If there is an event of default under the mortgage loan, the mezzanine lenders can avert a foreclosure on the mortgaged property by curing the mortgage loan, foreclosing on the equity interest and remedying the default as the replacement borrower or buying out the mortgage lender at face value. Given the large size of the mortgage loans, buying out the mortgage lender will not be an option for an average mezzanine lender. Care should be taken in analyzing real estate transfer taxes, which might apply not only to (judicial or non-judicial) foreclosure sales but also to transfers of equity interests at UCC foreclosure sales.

### Purchase and Sale of Distressed Debt

One option available to an owner of a distressed loan is to sell it in the secondary market. A variety of considerations influence a lender's decision to sell. Driving factors may be a need for liquidity, shareholder or board pressure to reduce exposure to a certain asset or asset class, and the impact of a discounted sale on the lender's books and financial statements. Those who opt to sell may be more concerned with the speed and certainty of closing than with price. The loan seller's main objective for the loan documentation will be to have a final sale with minimal exposure to indemnity or liability claims after the sale. The loan should be sold "as is" and the seller will seek to limit its representations and warranties to its formation power and authority to execute and deliver the loan-purchase agreement. There will likely be no representations or warranties as to the loan itself except that the seller owns it free and clear. The absence of loan-specific representations and warranties puts the onus on the purchaser to conduct thorough due diligence on the borrower parties, the property and the loan documents, including obtaining estoppel certificates from the loan parties, property manager and any other relevant parties. The seller will want to establish a cap and time limit on its exposure to any indemnity claims and will also likely seek a floor amount for any liability to ward off *de minimus* indemnity claims. The purchaser in turn may want a portion of the purchase price to be held in escrow for a certain period of time after closing to satisfy any indemnity claims it may have.

### Bankruptcy

Commercial real estate loans are often structured as "bankruptcy-remote" loans to minimize the risk that a borrower might be consolidated with its parent in the parent's bankruptcy. While such bankruptcy remote structures, to the extent effective, might prevent the risk of substantive consolidation with affiliates of the borrower, such structures do not provide effective protection against the borrower's bankruptcy if the borrower itself becomes insolvent due to a shortfall of property revenue, because it is overleveraged, or for other reasons. If the borrower was structured as a bankruptcy-remote entity, its organizational documents will restrict it from filing for bankruptcy without the consent of the independent director. While an independent director working for a service company that has been selected by the lender might be reluctant to vote in favor of bankruptcy at the first sign of distress, the director is ultimately bound by its fiduciary duties to the borrower and will likely vote in favor of bankruptcy if it is in the best interest of the borrower. Also, if the borrower retains the right to replace the independent director, it may find more willing replacements. So far, it appears that bad-boy guaranties have served as a powerful deterrent for a borrower to file for bankruptcy. As discussed above, if a borrower voluntarily files for bankruptcy the bad-boy guaranty will grant full recourse to the guarantor for the entire debt. Regardless of the mitigating effect of bankruptcy-remote structures and bad-boy guaranties on voluntary bankruptcy, a borrower might still end up in bankruptcy, either because it or a guarantor decides to test the structure, third party creditors initiate involuntary bankruptcy proceedings, certain parties indemnify the borrower or guarantor for its bad-boy acts to incentivize the borrower to file, or the borrower fears a breach of fiduciary duty claim for not filing for bankruptcy more than the bad-boy exposure. If the guarantor itself is insolvent, the bad-boy guaranty might not act as a deterrent since the guarantor might not care about the (unsecured) recourse claim against him. If the guarantor loses its role as manager, managing member or general partner of the borrower and is replaced (as organizational documents may allow if the loan goes into default), the person replacing the guarantor will not be liable under the guaranty and therefore may not care if a bankruptcy filing will result in personal liability for the guarantor. A borrower will most likely file for bankruptcy under Chapter 11 of the Bankruptcy Code, seeking reorganization rather than liquidation. Its primary motivation will be to avoid foreclosure, to de-lever and to hold on to its interest in the property until markets improve.

The immediate effect of a bankruptcy filing will be the automatic stay, which will immediately prevent a lender from exercising remedies and foreclosing on the collateral. While the lender is stayed from enforcing its rights and remedies against its collateral the borrower, as debtor-in-possession, may continue to use, sell or lease its property, including the lender's collateral, in the ordinary course of business without prior court approval, provided that the lender is adequately protected and that the collateral is not cash collateral. For the debtor to use cash collateral (such as rents or other property income), either lender consent or court approval is required. A court will approve the use of cash collateral if "adequate protection" is provided to the lender. Adequate protection may be of particular concern in a market environment in which property values, and therefore the value of a lender's collateral, will likely decrease. Adequate protection may take the form of a one-time or periodic cash payment or the grant of an additional or replacement lien to offset any decrease in the value of the lender's interest in the collateral, or any other form of relief that permits the lender to realize the "indubitable" equivalent of its interest in the collateral. In a declining real estate market, adequate protection concerns are often the focus of litigation.

An interesting cash collateral issue frequently litigated is who owns the rents. While most assignments of leases and rents in commercial real estate financings are structured as absolute assignments to the lender with a license granted back to the borrower to collect the rents until an event of default has occurred, such assignments are not usually interpreted as conveying the lender title to the rents. In the few jurisdictions where such assignments are viewed as absolute, the rents would be property of the lender and would not form part of the bankruptcy estate. However, courts will typically view such an absolute assignment with a license of collection as a "conditional absolute assignment" that constitutes a security interest only. Accordingly, rents will typically be treated as cash collateral.

In bankruptcy, a sale of real estate outside the ordinary course of business requires a court order. Under such an order, real estate can be sold free and clear of liens, with the liens attaching to the proceeds of the sale, provided that the lender consents, or the collateral is sufficient to repay the lender in full, or (in certain jurisdictions) if collateral values are realized. Lenders can credit-bid their debt in bankruptcy in a manner similar to what transpires in a state court foreclosure proceeding.

The lender can seek to modify the automatic stay so as to pursue its contractual remedies. To do so, it must demonstrate that either it is not being adequately protected (*i.e.*, the real estate is declining in value and it is not being paid an amount equal to the deterioration), or the debtor has no equity in the real estate (taking into account all the liens against the property) and the property is not necessary for an "effective reorganization." Effective reorganization means a likely reorganization within a reasonable timeframe.

In order to combat wasteful debtor tactics in real estate cases, the Bankruptcy Code was amended to create a more expedited procedure for "single-asset real estate" ("SARE") cases. A SARE case is defined as one involving a single property (other than residential real estate with fewer than four units) which generates substantially all the borrower's income. In a SARE case, after 90 days the debtor must either have filed a plan of reorganization with a realistic chance of being confirmed or the lender will need to start being paid interest on its mortgage.

There are four primary requirements to confirm a plan of reorganization in a real estate case:

- One impaired class of creditors must vote to approve the plan. Impaired creditors are those not being paid in full in a timely manner. Approval requires the votes of creditors representing two thirds of the amount of claims of those creditors in the class actually voting and a majority (above 50 percent) of the number of creditors in the class actually voting.
- The plan must provide each creditor more than it would receive if the debtor was liquidated.
- The plan must be feasible — there must be a realistic chance that the debtor will be able to perform its obligations under the plan.
- The classes must vote to accept the plan, or the "cram-down" provisions of the Bankruptcy Code must be satisfied.

For a secured creditor, the cram-down requirements are satisfied if the lender receives the value of its collateral either in payment or a note (reorganization equity securities will not be adequate). For an unsecured creditor, the cram-down requirements are satisfied if the unsecured claim is paid in full (which is unlikely), the equity is not receiving anything under the plan or, in certain jurisdictions, the equity is contributing "new value" to the plan which justifies the receipt of consideration. How much new value justifies how much equity is often the subject of major contention. Debtors who face a major tax recapture if their equity is eliminated under a plan will often litigate the new value issue to avoid this result.

Sometimes a non-recourse lender is concerned that it will be crammed down because of severe market conditions and artificially low property values, and the inevitable market rebound has not yet occurred. In those limited circumstances, the lender will take the 1111(b) election, if available. If this election is taken, the lender will receive a new debt instrument equal to the face amount it is owed, but the present value of that debt instrument will be equal only to the value of the collateral. A lender will take this debt instrument, even at a low interest rate or for a very long maturity, if it expects that the market will rebound, that the borrower will want to sell the property and that the lender's full debt will be repaid long before the scheduled maturity.

A number of litigation issues arise as part of the plan process. These include whether the lender's deficiency claim will be classified with the other unsecured creditors; if so, whether the lender's vote against the plan will control the unsecured class and assuming the lender votes no on its secured claim, whether there will be an impaired class voting to approve the plan (if not the plan cannot be confirmed); determining the value of the property for purposes of secured creditor cram-down; determining the appropriate market rate of interest on the new debt instrument to be given to the new lender; whether there is a cushion in the lender's collateral to justify paying it post-petition interest and attorneys fees; and whether the debtor's projections demonstrate that its new debt can be serviced and that the plan is therefore feasible.

In a deteriorating real estate market, structuring a plan of reorganization to preserve the debtor's equity presents a daunting challenge. The challenges involved with satisfying confirmation requirements are numerous.

Chapter 11 bankruptcy can be an expensive process and lingering in Chapter 11 can negatively impact the value of the property. In a situation where creditors are essentially trying to de-lever the borrower, they will negotiate the terms of a plan prior to the bankruptcy filing, essentially asking the court to bless the agreed-upon solution. Such an approach is colloquially referred to as a prepackaged bankruptcy.

In addition to owning real estate, debtors often lease it. In bankruptcy, leases can be either assumed or rejected by the debtor, with court approval, in accordance with the debtor's business judgment. The Bankruptcy Code limits the time (to seven months if cause is shown) within which commercial leases must be either accepted or rejected. Until the leases are rejected, the debtor must pay the contractual rent. Upon rejection, a damage claim will be treated as unsecured and will be capped at the pre-petition rent, plus one year's rent, or 15 percent of the remaining rent, not to exceed three years, whichever is greater. If the term of the lease is less than seven years, then the one-year cap rather than the 15 percent formula will be used. If the debtor wants to assume the lease, it must cure the defaults, compensate for damages arising from the default (late charges and attorneys fees) and provide adequate assurance of future performance under the lease. Bankruptcy termination clauses or anti-assignment clauses are not enforceable for real estate leases.

Please refer to Chapter 29: Bankruptcy Aspects for a more detailed description of the bankruptcy process.

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# Chapter 31

## THREE FACTORS FOR SUSTAINABILITY: GEOPOLITICS, OCCUPIER MANDATES AND URBAN COMPETITIVENESS

Michael P. Buckley, Columbia University, with additional research by
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Commercial property owners and investors in the US confront a unique situation as occupiers, government and key "gateway" cities pressure owners and developers to focus on sustainability.

Investors must now recognize that these factors will produce a user-driven desire for sustainability, and, in many cases, legal requirements affecting both existing stock and new development products. These factors, more than the growing acceptance of the threat of global warming, and well beyond the philosophical underpinnings of environmental responsibility, are combining to define a new sustainability mandate.

The geopolitics of foreign oil dependency have brought about explicit US government support of sustainability — from broad and extended tax incentives for retrofits to new seed money in the Obama stimulus package. The target dates for these expenditures are compressed to influence economic revitalization. The strategic and tactical applications produced by these investments have a real chance of creating new green industry.

More and more occupiers have begun to mandate green office buildings, and the interest is spreading. The mandate stems principally from the GSA, the largest occupier in the US, requiring all its occupied space to be green, and from *Fortune* 500 companies who recognize the benefits of clean air and day-lighting standards on increased productivity and reduced absenteeism.

Many key gateway cities have announced ambitious sustainability plans with fixed dates for compliance in an effort to maintain competitive advantage in the global economy. Steps include major city ordinances and strategic action plans. Several urban areas have responded to the green agenda with programs for buildings, substantial vehicle fleets and especially transit systems. These include New York, Boston, Washington, DC, Los Angeles, Portland, Seattle, San Francisco, Chicago and Atlanta.

### Environmental Responsibility

The impact of existing buildings on the US ecosystem is compelling, as these structures are large users of natural resources. Existing buildings:

green building design specialist participating at every stage

- location and neighborhood fabric — locations developed should conserve resources, take advantage of existing infrastructure and civic amenities, be close to transportation and contribute to the fabric of healthy, livable communities
- improvement sites — locations will be chosen to conserve natural resources, improve operational efficiencies, enhance health and promote non-automotive means of transit
- water conservation — using water-efficient appliances and fixtures, low-water landscaping and irrigation, and rainwater and grey water (water recaptured and recycled from showers, sinks and clothes washers) when possible
- efficiency — energy efficiency is to be a guiding principle in all stages of development, construction methods, design of insulation for efficient heating and cooling, use of Energy Star™ appliances, and efficient interior and exterior lighting
- materials beneficial to the environment — including reuse and recycling on the construction site to decrease waste, and use of building products and techniques that contribute to more durable, healthy and resource-efficient buildings
- healthy living environment — including the use of safe biodegradable materials, such as paints and primers, adhesives and sealants; use of materials and construction techniques to reduce mold; and ensure adequate ventilation and garage isolation
- operations and maintenance — training for employees and residents to explain and assist in the preservation of the property's green character.

The mayor's green team is a collaborative effort by District agencies to improve environmental practices. The team consists of more than 80 members from over 40 agencies who seek to find innovative solutions and to overcome inter-agency implementation challenges. Active working groups have been formed on the issues of climate change, greening government buildings, outreach and education, and recycling.

**San Francisco**

Well known for progressive social action, San Francisco is California's most aggressive green advocate, as several new programs will attest.

- Electric Vehicle Charging Stations — the city has formed a partnership with car sharing organizations Zipcar and City CarShare to make plug-in cars available to the public and to the municipal vehicle fleet. The program is part of a "green vehicle showcase" to highlight green transportation options, including natural-gas vehicles, car-sharing systems and electric cars. "Electric vehicles are the future of transportation and the Bay Area is the testing ground for the technology," said San Francisco Mayor Gavin Newsom. "We began using plug-in hybrids in the city's fleet last year. Now, for the first time, the public can plug-in to the next generation of cars through car sharing organizations and take them for a drive in San Francisco."
- Grants from US Environmental Protection Agency and California Energy Commission fund an innovative San Francisco pilot project to turn waste grease into biofuel. This project can potentially serve as a model for cities throughout the nation. The city plans the first brown grease-to-biodiesel plant. San Francisco is collecting waste vegetable oil from restaurants for free and recycling into biodiesel, an environmentally friendly alternative to petroleum diesel. Municipal fleets will soon run on biofuel made from used cooking oils provided by local restaurants.
- The Clean Energy Loan Program, the largest loan program of its kind in the US, would provide low-interest loans to residents and businesses for solar and energy-efficiency upgrades. The program will loan money to San Francisco residents and businesses to install solar energy systems on their rooftops and make energy-efficiency upgrades to their buildings.

  To encourage more installations of solar power in San Francisco, the city is offering incentives to residents and businesses to install solar power on their properties. The program, GoSolarSF, coupled with the California Solar Initiative, a state rebate program and federal tax credits, could pay half or more of the cost of a solar power system installed in San Francisco.

- San Francisco's latest initiative to recycle compostable garbage will require even more sorting from restaurants and residential units, but, if successful, will certainly be adapted by other cities.

### The Sustainable Conclusion

These gateway city initiatives illustrate the range of attitudes and emphasis on sustainability. By 2020, Columbia's Center for High Density Development predicts that all new commercial developments will consider sustainability and mandates from city and corporate occupiers will require green solutions — and that US gateway cities will lead in legislation enabling these solutions.

Furthermore, the government's massive investments in sustainability processes will yield unexpected innovations and a strong set of applications, much as the heavy flow of funds to the dot-coms in the 1990s produced virtually all of the software processes used in Internet sales today. Multi-layer Web sites with embedded flash video, the Internet shopping basket and secure payment systems were all byproducts of that era, and are now ubiquitous and available at a fraction of their first-mover costs.

The sustainability stimulus will generate a new set of methodologies and changed mindsets, along with efficient applications readily available at low costs. Green new construction and, more importantly, the mandated upgrades to existing stock, will all produce substantial operating-cost efficiencies and will be cleaner, healthier and more productive environments. Paybacks will be faster in the US gateway cities, as these have the highest property-operation costs. Investors must heed this prediction and act with purpose.

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As president of Halcyon Ltd, Michael Buckley advises on strategic planning for under-utilized sites such as Washington's Navy Yard and IMC Center Qingdao China, disposition strategies for Fortune 50 corporations such as Pitney Bowes, and for international pension funds such as KLM. Redevelopment initiatives include NYC's East Side Access/Grand Central and San Francisco's Transbay Center projects. Historic re-use includes Hartford's Union Station. He currently heads Columbia's Center for High Density Development and is Visiting Professor, UTA Dallas.

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