The Real Estate Law Review

Tenth Edition

Editor
John Nevin

The LawReviews

THE REAL ESTATE LAW REVIEW

TENTH EDITION

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John Nevin

THE LAWREVIEWS

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PREFACE

Just as the ninth edition of *The Real Estate Law Review* was being published, the world was thrown into total confusion by the rapid spread of a deadly new disease. Covid-19 has affected the global economy like nothing this generation has experienced, with every major jurisdiction forced into a series of lockdowns. However, it must not be forgotten that the pandemic is primarily a human tragedy with more than 93 million cases globally and 2 million deaths. As we begin to see light at the end of the tunnel, the global health crisis will undoubtedly complete its transition into an economic one, with significant global debt and widespread unemployment. Covid-19 will leave its mark on all aspects of how we live and work, including each and every sector of the global real estate market.

A great deal has happened since the first edition of *The Real Estate Law Review* appeared in 2012, but nothing more significant than the covid-19 pandemic, a truly global crisis. This tenth edition of *The Real Estate Law Review* will continue to prove its worth by providing readers with an invaluable overview of how key markets across the globe operate and how they react to major world events. Covid-19 has served as a stark reminder that it is no longer possible to look at domestic markets in isolation. Investors and their advisers need to understand real estate assets in the context of global events, and *The Real Estate Law Review* continues to help its readers to do just that.

This edition extends to 27 key jurisdictions around the world, and I am very grateful to all the distinguished practitioners for their insightful contributions. Each chapter has been updated to highlight key developments and their effect on the relevant domestic market. Together, the chapters offer a helpful and accessible overview of the global real estate market. Overseas investors are key influencers in most markets, and it is vital that practitioners are able to advise on a particular deal in the light of an understanding of their client's own jurisdiction.

In the year that the UK finally left the EU and Joe Biden became president of the United States, the significance of Brexit and American politics have been put into perspective by the covid-19 pandemic. Covid-19 is a truly global issue affecting every jurisdiction and, of course, its real estate market. In the background, and almost forgotten, Brexit and the associated economic and political fallout has continued to be a concern for the UK economy and its real estate markets. Although investment volumes fell off a cliff in the first half of the year, we have started to see interest from both overseas and domestic investors, underlining the continued importance of UK real estate as an investment asset. The world's cache of investment capital is likely to prompt a surge in investment activity once some degree of confidence returns. The UK, and London in particular, seem certain to remain attractive to overseas investors looking for a safe haven for their funds. The next few years will undoubtedly be challenging as we begin the road to recovery, but opportunities will arise, and real estate will remain a key part of investment strategies.

Once again, I wish to express my deep and sincere thanks to all my fellow contributors to this tenth edition of *The Real Estate Law Review*. I would also like to thank the members of the Law Review team for their sterling efforts in coordinating the contributions and compiling this edition. Finally, I wish everyone the very best of health for 2021 and beyond.

John Nevin
Slaughter and May
London
February 2021

Chapter 28

UNITED STATES

Meredith J Kane[1]

I INTRODUCTION TO THE LEGAL FRAMEWORK

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

i Ownership of real estate

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

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

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

Where a fee simple owner wishes to convey a long-term interest in the real estate asset to a third party but wishes to retain the underlying fee title, typically for reasons of taxes or inheritance, the fee owner will commonly enter into a long-term ground lease that will enable a third party to lease, develop and operate the real estate for the lessee's account. Ground leases are usually of at least 49 years' duration, and are often 99 years or longer. These long terms are necessary for the ground lessee to finance the development of the real estate and to amortise its equity investment in development of the real estate. A ground lease is a fully net lease, where the lessee develops, finances, operates, maintains and insures the property for its own account. Financing for the acquisition and development of the leasehold interest is secured solely by the lessee's interest in the ground lease, and not by the fee interest itself, which remains superior to the lease and the financing. From the standpoint of the safety of a real estate investment, a ground landlord's position under a ground lease, where the lessee has invested in improving the real estate, is among the most secure investments available.

1 Meredith J Kane is of counsel to the real estate department at Paul, Weiss, Rifkind, Wharton & Garrison LLP.

ii System of registration

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

iii Choice of law

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

Choice of law in real estate transactions can vary based on the transaction document in question. Ownership entities will usually be established either under Delaware law (which has become the standard for sophisticated financing transactions, including securitised financing) or the law of the state in which the real estate is located. One advantage to forming an entity under the law of the state where the real estate is located is that a Delaware entity will also need to register to do business in the state in which the real estate is located.

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

II OVERVIEW OF REAL ESTATE ACTIVITY

The covid pandemic has ushered in a profound period of uncertainty and dislocation of the urban real estate markets in the United States. The closing of office spaces in March 2020 as the world entered covid lockdowns, coupled with the abrupt shutdown of international and domestic tourism and business travel, and of the related services and retail in the central business districts, has led to large-scale vacancies throughout the central business districts of New York City and other major cities. A snapshot of the New York real estate market at the end of the second quarter of 2020 showed a very bleak situation:

a Commercial leasing was off 69 per cent below its five-year quarterly average – the lowest quarterly total on record and 30 per cent below the leasing rate at the height of the 2008 financial crisis. New lease commitments have been largely short-term extensions, rather than long-term leases. Office rents are projected to decline by over 15 per cent. The overall rate of office availability is the highest of the twenty-first century, with space offered for sublet by existing tenants exceeding nearly 25 per cent of overall availability, which is considered an unhealthy market. Share prices of the major New York office REITS are off 50 per cent over the year.

b Citywide investment sales transaction volume – buying and selling of commercial property – declined by 32 per cent and consideration declined 54 per cent year-over-year.

c The residential rental market has median net effective rents down over 10 per cent and a vacancy rate exceeding 5 per cent, which is the highest in over 50 years.

d Retail vacancies in Manhattan have hit record numbers. Common practice for nearly every retailer has been to negotiate (and litigate, where negotiation failed) to reduce their lease rents during the shutdown months, with rent reductions sought for the remaining lease term as well. Storied retailers, both specialty and department store, have been declaring bankruptcy and closing mall and free-standing stores.

e Hotels have been extremely hard hit. Over 20 per cent of all loans were delinquent over the course of the year. Hotel investment sales transactions declined 70 per cent, consideration declined 81 per cent and the average price declined 37 per cent year-over-year. Over 20 per cent of New York City's hotel rooms may have permanently closed.

f Ridership on the NYC subway during rush hours was down over 70 per cent (up from a low of 90 per cent at the worst of the pandemic), and on suburban trains has fallen over 85 per cent. The Metropolitan Transportation Authority, which operates New York City subways and regional commuter rail systems, faces projected revenue losses of US$14 billion for 2020–2021, 41 per cent of its total budget. It is looking at postponing key aspects of its US$51 billion capital programme indefinitely, and instituting service cuts by up to 40 per cent on major subway lines.

g The New York City budget is facing a deficit of US$10.4 billion out of a total proposed 2021 fiscal year budget of US$88 billion. New York State anticipates a US$8–US$9 billion shortfall for 2021, with projected state tax revenue declines of up to US$64 billion through 2024. Among the taxes that New York City and New York State, as well as the Metropolitan Transportation Authority, rely on are a host of real estate transaction taxes (real property transfer tax, mortgage recording tax, commercial rent tax, hotel occupancy tax), all of which are down by double-digit percentages.

As at the end of 2020, the overall success of the 'work from home' experience in office work has led to a general expectation that the office market will be permanently changed as a result of the pandemic. With it go the central business retail and services markets that depend on a core daily central business district population, as well as patterns of housing and commuting that favoured location in high-cost areas close to high-paying jobs. Among the unresolved questions are:

a Is this finally the opportunity for more far-flung locations to break the stranglehold that the 'gateway cities' have held on economic development, and to broaden the base of economic and real estate activity across the country?

b What changes in real estate product types will be in demand for the new live-work paradigm?

Much has been written anticipating the future of cities, the future of the workplace and the future of housing and commuting patterns, all of which will play out in the years to come. One bright spot in a year of bleak news was the market for warehousing and logistics space, which is in high demand as retail sales shift increasingly to e-commerce. Projections are for net absorption to reach nearly 250 million square feet in 2021 – more than the previous five-year annual average. This will spur both new construction, which is already at near-record levels, and conversion of vacated retail space.[2]

III FOREIGN INVESTMENT

The US commercial real estate markets remain an attractive investment target for foreign capital seeking a stable political environment and stable currency. Commercial real estate remains a relatively attractively priced asset, with the potential to generate substantial operating income and capital gains as markets continue to expand. Because of the global covid-19 pandemic, 2020 was an atypical market. For 2018 (the previous period for which reliable statistics are available), direct foreign investment in commercial real estate totalled US$94.9 billion. The major source of foreign capital was Canadian funds, which accounted for nearly 50 per cent of 2018 foreign investor activity. There was a noticeable drop-off in volume coming from Chinese investors due to the tighter monetary policies in that country, but capital investment from other parts of Asia, especially Singapore, Japan and Hong Kong, continued to be strong. 'Platform' or entity-purchase deals led the foreign investment market, with several sizable deals for mall and office space operators. Foreign capital continued to move beyond core gateway markets and into other property types aside from office and hotels, such as industrial, multifamily and alternatives that include medical office, healthcare and data centres. This represents a marked expansion of investment strategies beyond prior years, in which foreign investors heavily focused on high-quality assets in primary office markets. Multifamily assets purchases represented about US$15 billion in foreign capital, representing a 30 per cent increase over the prior year.[3] Following a trend that domestic investors also initiated this year, given the high pricing of real estate assets in primary markets, increased foreign investment was deployed to purchase assets in secondary and tertiary US markets.

Foreign investment in luxury US residential real estate dropped significantly in 2018. For 2018, foreign homebuyers dropped off 36 per cent from the previous year, purchasing only US$78 billion in properties, compared with US$121 billion in the preceding year. Chinese

2 Source: CBRE Industrial and Logistics: 2021 US Real Estate Market Outlook.

3 Source: National Real Estate Investor, March 11, 2019, citing Real Capital Analytics study. Newmark Knight Frank, 'Foreign Investment in US Commercial Real Estate', December 2017.

buyers dropped off the most, with purchases falling 56 per cent to an estimated US$13.4 billion of residential property. Florida, California and Texas were the top destinations for foreign home buyers.[4] Notable were the declines in all-cash purchases, as well as the decline in purchases of ultra-luxury condominiums in New York City.

i Foreign Investment in Real Property Tax Act

Foreign investment in US commercial real estate is generally done through a US-taxpaying entity, in order to avoid the 15 per cent withholding tax provisions of Internal Revenue Code Section 1445(a), implementing the provisions of IRC Section 897, the Foreign Investment in Real Property Tax Act (FIRPTA). The most commonly used US-taxpaying entity for foreign investment is a US corporation that is a wholly owned subsidiary of the foreign investor. As with LLCs and LPs, corporations are also organised under state law, usually either Delaware or the state in which the real estate is located. The foreign investor is thus subject to US income tax with respect to the ownership and operations of US real estate, including capital gains taxes on dispositions. At the end of 2015, long-sought amendments to FIRPTA were enacted into law, expanding exemptions from US taxes for foreign pension funds that invest in US REITs or directly in real estate, thus putting foreign pension funds on similar a tax footing to US-based pension funds. This change is intended to, and expected to, increase foreign pension fund investment in US real estate.

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

ii EB-5 Immigration Program for Investment in Job Creation

An incentive for foreign investment which has become increasingly widespread in use over recent years is the EB-5 programme, under which a foreign national becomes entitled to receive an employment-based fifth preference (EB-5) immigrant visa in return for investing in a new commercial enterprise within a US government-designated regional centre. New federal rule-making in 2019 tightened requirements for both investments and visas, in response to perceived programme abuse in recent years. The new required investment is US$1.8 million of foreign capital (up from US$1 million in prior years), which is reduced to US$900,000 (previously US$500,000) for an investment in an area of high unemployment or in a rural area. The investment must create at least 10 full-time US jobs. The EB-5 investment is structured either as a preferred equity investment with a fixed return, or as secured debt. EB-5 investment has become a primary source of low-cost investment capital for real estate development projects, where jobs are generated through construction activity as well as business occupancies. China is the main source of EB-5 investment dollars for US real estate transactions, exceeding 85 per cent of the EB-5 applications over the last five years. The EB-5 programme was recently extended to 30 June 2021, largely as a result of strong lobbying by the real estate industry. Its future after that point is uncertain.

4 Source: Forbes July 18, 2019, 'Foreign Investment in US Real Estate Plunges'.

iii Committee on Foreign Investment in the United States (CFIUS)

New federal regulations went into effect on 13 February 2020 that expanded the authority of the Committee on Foreign Investment in the United States (CFIUS) to examine national security risks posed by foreign deals. Under CFIUS, a Treasury Department-chaired interagency body reviews the national security risks of proposed cross-border transactions, and has the power to reject transactions which threaten to impair US national security. Real estate, which historically had been exempt from CFIUS, is now subject to reviews by the inter-agency panel, exposing a greater number of deals to the risk of rejection by the US government. The new regulations grant CFIUS the authority to review foreign investment in real estate that: (1) is located within, or will function as part of, an airport or maritime port; (2) is in close proximity to a US military installation or another facility or property of the United States government that is sensitive for reasons relating to national security; (3) could reasonably provide the foreign person the ability to collect intelligence on activities being conducted at such an installation, facility, or property; or (4) could otherwise expose national security activities at an installation, facility, or property to the risk of foreign surveillance if the investment gives the foreign investor certain property rights. The new regulations offer a path for companies based in Australia, Canada and the UK – key US allies – to win exceptions to avoid CFIUS inspection.

IV STRUCTURING THE INVESTMENT

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

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

A major advantage of an LLC or LP structure is that an investor is not liable for the debts or liabilities of the title-holding entity beyond the funds invested in the entity. Thus, an investor is insulated from property liabilities through this investment structure, including property-level debt. A second major advantage is that both LLCs and LPs are 'pass-through' entities for federal income tax purposes, meaning that all income and losses of the entity are passed through to the members and taxed solely to the members, with no second level of tax at the entity level. Investors can use income and losses of the property to offset income and losses of other real estate investments for tax purposes, and tax-exempt investors can enjoy fully tax-exempt income. The recently adopted US federal income tax overhaul further advantage the use of pass-through structures by providing for a 20 per cent deduction for all income earned through pass-through entities, before the individual tax rate is applied.

Typical provisions of the LP or LLC agreement describe:

a the capital contributions of the parties, obligations, if any, of the parties to contribute additional capital to the entity, and rights and remedies if a party fails to make required future contributions;

b the decision-making process of the entity, including major decisions that will require approval of all or a majority of the investors;

c the timing and priority of distributions of available cash and capital proceeds to the parties, including preferred returns and carried or promoted interests;
d allocations of income, gain and loss for tax purposes; and
e exit rights of the parties, including buy-sell rights, forced-sale rights, and provisions governing sales of interests and rights of first offer or refusal.

Another relatively common structure for ownership of real estate is the REIT. This structure, defined by Section 856 of the Internal Revenue Code, is used to hold interests in real estate where maximum liquidity is desired. The REIT is organised as a corporation with shareholders, in which the shares may be publicly or privately traded. In order to enjoy a 'pass-through' tax treatment similar to LLCs and LPs, including the new 20 per cent deduction from taxable income, a REIT is required to meet prescribed IRS requirements, including that it distribute 95 per cent of its taxable income annually, that it invest at least 75 per cent of the value of its total assets in real estate or real estate mortgages, and that it derive at least 75 per cent of its gross income from real property rents, interest, proceeds of sale and similar. Most REITs traded on the US markets today are large corporations with multiple property holdings, usually in a single asset class (residential or office), but often in multiple geographic markets to provide asset diversification to REIT investors.

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

V REAL ESTATE OWNERSHIP

i Planning

Planning and land use issues are largely controlled by states and municipalities, through the mechanism of zoning laws adopted by local jurisdictions. In rural and suburban areas, zoning laws focus on master plans for large-scale developments and related infrastructure, with a focus on controlling density, preserving open space and ensuring that there is adequate water, sewer capacity and other necessary utilities for developments. Preservation of wetlands and natural habitats of endangered plant and animal species are controlled by federal laws, in addition to local zoning laws. In urban areas, zoning laws will prescribe, for each specified zoning district, the uses to which real estate can be put (industrial, commercial, residential or institutional), the density of development (number of square feet of building space per unit of land area), the height, the distance from the property boundaries to the building or buildings, overall architectural configuration of individual buildings, the sizes and configurations of yards and open space and street frontages. Zoning laws often contain incentives or requirements for developers to provide public benefits, such as affordable housing, parks and other public amenities in connection with a new development. Many localities also require preservation of designated landmark buildings. Legal challenges to land use regulations continue to be brought in state and federal courts, which set the limits of how far government can go in regulating the uses to which land can be put without constituting an unconstitutional 'taking' of the private property of the landowner.

ii Environment

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

iii Tax

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

iv Finance and security

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

VI LEASES OF BUSINESS PREMISES

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

i Office leases

Typical provisions of office leases are as follows.

Term and renewals

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

Base rents and operating expenses

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

Tenant improvements

An office landlord will pay for initial improvements to the office space, or provide an allowance to the tenant to pay for improvements, and will provide a period of free rent at the beginning of the lease to enable a tenant to complete the work and move in. The cost of these concessions is factored into the rent.

Assignment and subletting

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

Building services

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

Default and termination

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

ii Retail leases

Retail leases differ from office leases in the following respects.

Terms and renewals

In today's volatile retail market, a new trend is the short-term (one year or less) 'pop-up' retail lease, with longer extensions after the initial try-out period.

Base rent

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

Percentage rent

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

Common area maintenance charges

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

Use clauses and continuous operation covenants

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

VII DEVELOPMENTS IN PRACTICE

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

i Opportunity zone investments

The opportunity zone incentive is a new community investment tool established by Congress in the Tax Cuts and Jobs Act of 2017 to encourage long-term investments in low-income urban and rural communities around the US by providing tax benefits to investors. First, investors can defer tax on any prior gains invested in a qualified opportunity fund (QOF) until the earlier of the date on which the investment in a QOF is sold or exchanged, or December 31, 2026. If the QOF investment is held for longer than 5 years, there is a 10 per cent exclusion of the deferred gain. If held for more than 7 years, there is a 15 per cent exclusion of the deferred gain. Second, if the investor holds the investment in the Opportunity Fund for at least ten years, the investor is eligible for an increase in basis of the QOF investment equal to its fair market value on the date that the QOF investment is sold or exchanged, thereby avoiding capital gains tax altogether.

ii Bankruptcies

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

a SPE borrowers that are part of an integrated operating group of companies may consider the interests of the entire group in determining to file for bankruptcy, and need not themselves be insolvent at the time of filing;[5] and

b it does not constitute bad faith for an SPE entity to replace its independent directors installed for the purpose of discouraging a filing, and replacing them with new directors willing to file if in the best interests of the operating group.[6]

iii Distressed debt acquisition as an investment opportunity

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

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5 *In re General Growth Properties, Inc., et al.* (Bankr. S.D.N.Y., Case No. 09-11977).

6 ibid.

iv Land use planning and climate change: 'Resilient' planning and building

Climate change is altering land use patterns throughout the US. The severe hurricanes and flooding in Houston and Florida, the lethal wildfires throughout California and the western US, and the rising sea levels across the heavily developed East Coast and Gulf Coast areas have led to a major reconsiderations of land-use patterns, waterfront development, development in flood- and fire-prone areas and building design and codes to enhance 'resiliency' in the face of long-term climate change. Flood disasters are severely constraining the liquidity of the US government's National Flood Insurance Program, which is critical to obtaining financing for real estate acquisition and construction in flood zones. Proposed changes to this programme include expanding flood zones to keep up with the reality of expanded flood risks through climate change, increasing rates to adjust for actual risk and loss experience, and require flood-resilient planning and building activities from local authorities and property owners. Wildfire losses, which are insured by private market insurers, have led to record losses, estimated in excess of US$14 billion, in 2018. The State of California, which accounted for the bulk of wildfire losses, is considering new regulations to diminish fire risk regarding construction in urban/rural interface areas, new building codes, utility operating standards and insurance company rate adjustments. In response to rising sea levels, New York City, among others, is implementing new technologies to prevent long-term damage to both public and building infrastructure from increasingly severe storm patterns, along with zoning and building code changes. On the building level, resiliency improvements include installation of back-up generators and flood gates, raising the location of building equipment and creating flood reservoirs in basements. On the public infrastructure level, resiliency reforms include retooling and waterproofing the electrical, transportation and communications grids, and rethinking waterfront zoning and development patterns.

VIII OUTLOOK AND CONCLUSIONS

As discussed above, the effect of the covid-19 pandemic on workplaces and urban apartment living has upended investment predictability in the real estate markets, including location of future demand, strength of future demand and type of product in demand. In the short term, the outlook for US real estate markets is to remain in a holding pattern, while the future patterns of working and living are established in a post-pandemic economy. That said, certain patterns of demand that were taking shape prior to the pandemic will clearly continue and be expanded, such as increased demand for logistics space and increased growth of e-commerce. As the effects of the covid vaccine take effect and people return to the workplace, market patterns will develop and markets will begin to adapt to the new post-covid reality.

Appendix 1

ABOUT THE AUTHORS

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

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

Ms Kane was honoured in 2019 as an inaugural New York Trailblazer by *New York Law Journal* and by *National Law Journal*, as a 2017 Law360 MVP in Real Estate, the 2012 'Best in Real Estate' at the Euromoney Legal Media's inaugural Americas Women in Business awards, 2009 Woman of the Year by WX – New York Women Executives in Real Estate, and was named one of the top 50 women in real estate and one of 25 current leaders in the industry by *Real Estate Weekly* and the Association of Real Estate Women. *Grid Magazine* named her one of the top 10 American women in real estate development. Commercial Observer has twice cited Ms Kane, as part of its Power 100 list, as one of the 'Power Attorneys', the top real estate lawyers who are 'the legal world's most powerful, most connected and most exciting players'. In 2015, Commercial Observer profiled Ms Kane individually as one of New York's most influential real estate attorneys. She is cited as one of the leading real estate lawyers in the United States in *Chambers USA*, *Who's Who Legal: USA*, *The Legal 500*, *The Best Lawyers in America* and numerous other peer-reviewed publications. She is a member of the prestigious American College of Real Estate Lawyers.

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