The Real Estate Law Review

Editor

David Waterfield

Law Business Research

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The Real Estate Law Review

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EDITOR'S PREFACE

In an age that has seen ownership of real estate become increasingly international, it is more necessary than ever to appreciate the basic framework of real estate law in different jurisdictions. This book aims to give readers a general feel and overview of some of the key substantive and practical considerations in the major markets around the world.

Each contributor to *The Real Estate Law Review* is a distinguished legal practitioner in his or her own jurisdiction, and this review represents an immediate and accessible summary of the most important and relevant issues across the many countries covered.

The Real Estate Law Review seeks to identify distinctions in practice between the different jurisdictions by focusing on key developments that highlight particular local issues – we believe that this will help practitioners to develop their understanding of practice beyond their own borders. As both domestic and international clients become ever more sophisticated in this regard, real estate practitioners need to be familiar with the issues in the markets that are most relevant to the interests of their clients. Overseas investors have for some time been key influences in most jurisdictions and it is therefore vital that practitioners are able to advise on a particular transaction in the light of an understanding of the investor's own home forum.

In addition to bringing together topical cross-border real estate issues and practical information on real estate practice around the world, *The Real Estate Law Review* also seeks to offer an overview of activity levels in each jurisdiction and, therefore, the global real estate investment market. The impact of events such as the collapse of the US sub-prime residential mortgage market and the Eurozone crisis has demonstrated how complex and inter-related investment markets have become. It is no longer possible to ignore globalisation and view real estate markets in isolation. The financial and economic turmoil of the past few years will continue to affect the international real estate investment market; the scarcity of debt finance seems likely to continue for the foreseeable future and investors with funds will increasingly look to a global real estate market for value and safety.

I wish to express my deep and sincere thanks to all my distinguished colleagues who have contributed to this first edition of *The Real Estate Law Review*. I would also like to thank Gideon Roberton and his publishing team for their tireless work in coordinating the contributions from the various countries around the world.

David Waterfield
Slaughter and May
London
February 2012

Chapter 35

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 V, *infra*.

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

In fee simple title ownership, the ownership entity owns all 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

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

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

ii System of registration

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

iii Choice of law

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

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

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

II OVERVIEW OF REAL ESTATE ACTIVITY

The US real estate market has been dominated since 2008 by the restructuring of large and small loans and equity investments throughout all asset classes to deal with the broad decline in property values that has occurred since the heights of 2005 to 2007. The restructuring trends are expected to continue into 2012 as an estimated $350 billion in commercial real estate financing matures, and must be refinanced in the current market environment of severely constricted debt markets, tightened underwriting standards and sharply lower property valuations. Recapitalisations require substantial new equity infusions, as leverage levels have decreased from first mortgage loan amounts that were commonly at 70 to 75 per cent for stabilised commercial properties in the mid-2000s, to levels that are more commonly 50 to 55 per cent in today's refinancing markets. Coupled with decreased property values, one source estimates that there is a $1 trillion equity gap needed to refinance US commercial real estate.[2] The primary sources for debt refinancing in 2012 will likely continue to be banks and insurance companies, as the commercial mortgage-backed securities ('CMBS') market continues to be weak. In 2011, total CMBS issuances equaled only $32.7 billion, less than 15 per cent of the $237 billion issued in 2007. New regulations adopted under the federal Dodd-Frank Financial Reform Act require that issuers retain a minimum of 5 per cent of the risk in future CMBS issuances, which is expected to reduce future securitisation capacity.

Commercial property sales throughout the US totalled approximately $215 billion for 2011, an increase of nearly 50 per cent over 2010. A large portion of transactions were recapitalisations, amounting to almost 35 per cent of total transaction volume in New York City alone.[3] As equity sources, publicly traded REITs, which raised a record

2 Source: The Real Estate Roundtable, 2011 Policy Agenda, Capital and Credit.

3 Source: Cushman & Wakefield, Capital & Leasing Market Overview, NY Capital Markets Group, 4Q 2011.

$51 billion in equity and debt in 2011, are expected to be active investors in property transactions.

In New York City, closed transactions in 2011 increased 88 per cent compared with 2010. The best-performing asset classes included core stabilised office buildings in these locations, which saw cap rates in the low 4 per cent to low 6 per cent range depending on geography, resurgent leasing activity (particularly large-block space) and increasing asking rents.

III DEVELOPMENTS IN PRACTICE

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

i CMBS loan originations and securitisation

There is an ongoing rethinking of all aspects of lending practices in the CMBS market, in response to the default and workout experiences over the past four years. On the loan underwriting side, improved protections of 'CMBS 2.0' include higher debt-service coverage ratios, lower loan-to-value ratios, and more conservative cap rate analysis and property valuations. On the securitisation side, protections include higher credit enhancement requirements, deeper junior tranches to support 'super-senior' tranches, and enhanced regulatory requirements, including the 5 per cent issuer risk retention described above. On the legal or structural side, protections include the use of an 'operating adviser' to represent the interests of all bondholders while a loan is in special servicing, transfer of the 'controlling class' rights based on appraisal rather than realised reductions in portfolio value to better align decision-making with the first-loss position, and a move towards uniform representations and warranties.[4]

ii Bankruptcies

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

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

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

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

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

iii Enforcement of non-recourse carve-out guaranties

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

a are not void as *ipso facto* clauses under the bankruptcy code, but are rather a legitimate and permissible mode of bankruptcy-remote structuring;[7]

b are not void as *in terrorem* clauses, but create an important deterrent effect to the behaviour sanctioned;

c do not constitute a penalty, or unenforceable liquidated damages, but represent an agreement to pay a valid debt of a sum certain;[8]

d do not induce breach of fiduciary duty or set up a conflict of interest for directors, whose duties are to the company and its shareholders and creditors, and not to the guarantor;[9] and

e are not void on public policy grounds favouring bankruptcy, because the real estate financial markets, consisting of powerful and sophisticated business interests, created another paradigm for dealing with lending risk and remedies that was designed to avoid bankruptcy courts.[10]

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6 Ibid.

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

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

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

10 See *FDIC v. Prince George Corp*, 58 F.3d 1041 (4th Cir. 1995), finding that a carve-out guaranty did not prevent borrower from filing, but guarantor would merely forfeit its exemption from liability for any deficiency.

iv Mezzanine lender enforcement of remedies and intercreditor agreements

Mezzanine loans, which are structurally junior debt to first mortgage loans and have as collateral a pledge of the ownership interests in the entity that owns real estate, are governed in part by intercreditor agreements with mortgage lenders entered into at the time of the financing of the property. Under a typical intercreditor agreement, a mezzanine lender is permitted to foreclose its collateral in the event of a mezzanine loan default, and following foreclosure to 'step into the shoes' of the borrower under the mortgage loan, without triggering a mortgage default. Once the mezzanine lender takes over the interests in the borrower entity, the mezzanine lender becomes liable to cure any defaults that were outstanding under the mortgage loan as of the foreclosure, to the extent susceptible of cure by the mezzanine lender. In at least two important recent decisions, state courts in New York and Arizona have refused to let mezzanine lenders foreclose their collateral unless all pre-existing mortgage defaults were cured prior to the mezzanine foreclosure, rather than following.[11] The effect of these decisions is to place significant obstacles in the path of the mezzanine lender attempting to foreclose its collateral, and to give the first mortgage lender significant leverage in workout negotiations.

v Distressed debt acquisition as an investment opportunity

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

11 *Bank of America, NA v. PSW NYC LLC*, 918 N.Y.S.2d 396 (2010) (enjoining the mezzanine lender from foreclosing on its equity interest in the mortgage borrower until after such lender cured all defaults under the senior loan, which included paying the accelerated balance of the loan totalling near $3 billion); *US Bank Nat'l Assoc v. RFC CDO 2006-1, Ltd*, Case No. 4:11-cv-664, Doc. No. 41 (D. Ariz. 6 December 2011) (enjoining the mezzanine lender from foreclosing on its equity interest in the mortgage borrower after the mezzanine lender failed to cure all defaults under the senior loan).

IV FOREIGN INVESTMENT

The US commercial real estate markets remain an attractive investment target for foreign capital seeking a stable political environment and stable currency. The market downturns of the past few years mean that commercial real estate is a relatively attractively priced asset, with the potential to generate substantial operating income and capital gains as markets continue to improve. Foreign investment in US real estate peaked in 2007 at approximately $50 billion, and has since declined to a low of under $12 billion in 2009.[12] As a percentage of all acquisition dollars, foreign investment accounted for approximately 10 per cent of funds invested in New York commercial real estate in 2011, a percentage that has remained relatively stable since 2009.

i Foreign Investment in Real Property Tax Act

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

ii Incentives

An incentive for foreign investment which has become increasingly widespread in use over the past five years is the 'EB-5' programme, under which a foreign national becomes entitled to receive an employment-based fifth preference (EB-5) immigrant visa in return for investing in a new commercial enterprise within a US government-designated 'regional center'. The required investment is $1 million of foreign capital, which is reduced to $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.

V 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

12 Source: 'Foreign Investment in US Real Estate, current trends and historical perspective', the National Association of Realtors, June 2010

or a managing member, and an LP is managed by a general partner. The investors are typically non-managing members or limited partners in the property-owning entities.

A major advantage of an LLC or LP structure is that an investor is not liable for the debts or liabilities of the title-holding entity beyond the funds invested in the entity. Thus, an investor is insulated from property liabilities through this investment structure, including property-level debt. A second major advantage is that both LLCs and LPs are 'pass-through' entities for federal income tax purposes, meaning that all income and losses of the entity are passed through to the members and taxed solely to the members, with no second level of tax at the entity level. Investors can use income and losses of the property to offset income and losses of other real estate investments for tax purposes, and tax-exempt investors can enjoy fully tax-exempt income.

Typical provisions of the LP or LLC agreement describe:

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

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

c the timing and priority of distributions of available cash and capital proceeds to the parties, including preferred returns and carried or promoted interests;

d allocations of income, gain and loss for tax purposes; and

e exit rights of the parties, including buy-sell rights, forced-sale rights, and provisions governing sales of interests and rights of first offer or refusal.

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

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

VI 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, setback and overall architectural configuration of individual buildings, the sizes and configurations of yards and open space, and street frontages. Zoning laws often contain incentives or requirements for developers to provide public goods, such as affordable housing, parks and other public amenities in connection with a new development. Many localities also require preservation of designated landmark buildings. Legal challenges to land use regulations continue to be brought in state and federal courts, which set the limits of how far government can go in regulating the uses to which land can be put without constituting an unconstitutional 'taking' of the private property of the landowner.

ii Environment

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

iii Tax

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

iv Finance and security

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

VII LEASES OF BUSINESS PREMISES

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

i Office leases

Typical provisions of office leases are as follows:

Term and renewals

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

Base rents and operating expenses

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

Tenant improvements

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

Assignment and sub-letting

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

Building services

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

Default and termination

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

ii Retail leases

Retail leases differ from office leases in the following respects:

Base rent

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

Percentage rent

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

Common area maintenance charges

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

Use clauses and continuous operation covenants

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

VIII OUTLOOK AND CONCLUSIONS

The prospects for 2012 transactions differ widely across the local markets. The core central business districts – New York City, Boston, San Francisco and Washington, DC – have rebounded in values and transaction volume more than other areas of the country, and are expected to continue doing so in 2012. Residential markets in these core areas, both residential rentals and condominiums, have also strengthened in transaction volumes and prices. Transaction momentum has, however, declined as the Eurozone financial crisis has begun to affect international markets.

In other regions of the United States, and in suburban areas outside of the core central business districts, office vacancies remain high and rents and values generally remain unimproved since 2008. The US housing market continues overall to be weak, with a large overhang of foreclosed properties depressing prices and sales volumes. Although interest rates remain at historic lows, mortgage underwriting standards have increased such that the total volume of new loans and refinancings remains below expectations.

The overall outlook for 2012 is for increased equity investment in core office and multi-family assets in core markets. The pace and value of growth and new real estate development, however, is directly dependent on improvements in the overall US and global economies.

Appendix 1

ABOUT THE AUTHORS

MEREDITH J KANE

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

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

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

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