



Real Estate

in 28 jurisdictions worldwide

2014

Contributing editor: Joseph Philip Forte



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United States

Curtis A Graham, Damon M Juha and Jill M Draffin

Freeman, Freeman & Smiley, LLP

GENERAL

1 Legal system

How would you explain your jurisdiction's legal system to an investor?

Many states follow common law, which means there are codified laws that are interpreted by courts following precedence or tradition, using decisions that have been made in similar situations.

In California there are three types of injunctions, including a temporary restraining order (TRO), preliminary and permanent injunctions. A TRO can be sought after a lawsuit has been filed. The party must meet certain legal standards including that it has been damaged and that monetary relief will be insufficient.

Courts will rule in equity, which requires taking into account a party's conduct. If a party has acted with 'unclean hands', courts will consider that party's conduct when ruling.

Parol evidence is a rule that prevents a party from presenting extrinsic evidence that contradicts the written contract. Courts prefer to rely on the writing unless the parties' intent is unclear from the contract. Rules of parol evidence vary from state to state.

Courts may enforce written and oral contracts. The latter is more difficult since courts are forced to rely on witnesses to confirm the existence and terms.

2 Registration and recording system

Does your jurisdiction have a system for registration or recording of ownership, leasehold and security interests in real estate? Must interests be registered or recorded?

Typically there is a recorder's office in each county. The recorder's office records ownership interests in real estate and other interests such as leasehold and security interests. Parties who have an interest in real estate routinely record their interests to inform others of their interest and, if they are lenders and have a security interest in the real estate, to assure their priority interest as a lienholder. The general rule is that whoever records their interest first has a higher priority. It is not a legal requirement to record but it is routinely recommended by attorneys.

3 Registration and recording

What are the legal requirements for registration or recording conveyances, leases and real estate security interests?

There are certain requirements to record documents (for example, in California, that the document is authorised or required by law to be recorded, to be of a certain size with certain margins, to have original signatures and, in many instances, to be notarised, and to have the name and address of the person requesting the recording). Also, the recorder's office requires payment of certain fees and taxes, which vary depending on the city and county.

4 Land records

What are the requirements for non-resident entities and individuals to own real estate in your jurisdiction? What other factors should a foreign investor take into account in considering an investment in your jurisdiction?

There are not many requirements for non-residents to own real estate, but there are tax consequences (the Foreign Investment in Real Property Tax Act of 1980 imposes a tax on foreign persons selling property in the United States, and in some states there are similar laws authorising withholdings from non-residents), reporting requirements (the International Investment and Trade in Services Survey Act requires that businesses report all foreign investment if a foreign person or entity owns 10 per cent or more of the voting interest in the US entity, subject to certain exceptions) and certain prohibitions (the Office of Foreign Assets Control Specially Designated Nationals and Blocked Persons List prohibits ownership by certain individuals, such as terrorists or drug traffickers, or the entering into agreements with them).

5 Exchange control

If a non-resident invests in a property in your jurisdiction, are there exchange control issues?

Currently there are no exchange control issues in the United States, although the federal or state governments may withhold taxes from non-residents under the Foreign Investment in Real Property Tax Act of 1980 and similar state laws.

6 Legal liability

What types of liability does an owner or tenant of, or a lender on, real estate face? Is there a standard of strict liability and can there be liability to subsequent owners and tenants including foreclosing lenders? What about tort liability?

Owners, lenders and sellers face several types of liability, some of which are the result of statutes passed by the local, state or federal government, including environmental laws, which require an owner not to permit hazardous substances on the subject property and to clean it up if it becomes contaminated. Other liabilities can be created by contracts between the owner and other parties. The federal government has created legislation to ensure contamination is removed from property, including making a buyer of contaminated property liable for cleaning it up even if the buyer did not know about the contamination. A buyer is expected to perform due diligence and proper testing before purchasing any property. There are state laws as well.

An owner of real property can be held liable to guests, invitees and third parties if they are injured while on the property. Landlords can be liable for failing to properly maintain their property, failing to disclose dangerous conditions, new constructions that are not

fit, failing to repair and maintain the premises, and failing to provide essential services. In some jurisdictions, an owner is required to provide additional disclosures about the condition of the property. Owners and landlords should be careful and seek legal advice because state laws continue to expand on the disclosures owners and landlords are required to make.

7 Protection against liability

How can owners protect themselves from liability and what types of insurance can they obtain?

Owners can own property in an entity, which provides one layer of protection.

Given the expense involved in remediating environmental matters, buyers should consult with a qualified environmental consultant and counsel to inspect the property before acquiring the same and being in the 'chain of title'. Environmental insurance can be obtained, but it can be expensive, may contain limits that do not cover all remediation costs and may have exclusions.

Owners can also obtain liability insurance (to insure against third-party claims for injury), title insurance (to insure against title defects), casualty insurance (to insure against property or physical damage), construction and rental interruption, among other coverages.

8 Choice of law

How is the governing law of a transaction involving properties in two jurisdictions chosen? What are the conflict of laws rules in your jurisdiction? Are contractual choice of law provisions enforceable?

It is not unusual for a contract to include parties from different states. In these situations, parties typically agree in advance which jurisdiction will resolve disputes between them. In their agreement, parties often agree on a 'choice of law' provision, which selects the state and state law in case there is a disagreement in the future. Before making an agreement, the parties should consider the laws in each state and how they might apply to their transaction, including how each state might interpret and enforce the agreement between them. If parties fail to agree to a 'choice of law' provision, then whichever party initiates litigation will likely file the case in its home state. Certain states, including California, liberally rule in favour of jurisdiction when one of the parties is a resident of that state.

9 Jurisdiction

Which courts have subject-matter jurisdiction over real estate disputes? Which parties must be joined to a claim before it can proceed? What is required for out-of-jurisdiction service? Must a party be qualified to do business in your jurisdiction to enforce remedies in your jurisdiction?

Subject-matter jurisdiction is the authority of a court to hear a particular case. The court must have jurisdiction over the parties or the issue in dispute. Not all courts can hear all cases. If parties are from different states and the action has been commenced in a party's home state, the other party may seek to remove it to federal court. Generally, if a real estate dispute arises between citizens of the same state, that state's court will have jurisdiction.

If the dispute is based on an alleged breach of contract, necessary parties include the parties to the contract. In real estate, necessary parties typically include anyone who has an interest in the property and the outcome, including the owner and possibly others.

Each state has its own rules on how to serve an out-of-state party. Many states have rules requiring an out-of-state entity to be

qualified in its state. This may include filing qualification papers and paying annual state fees and taxes.

10 Commercial versus residential property

How do the laws in your jurisdiction regarding real estate ownership, leasehold and financing, or the enforcement of those interests in real estate, differ between commercial and residential properties?

Residential real estate transactions (defined in California as single family homes and multi-unit buildings containing one to four units) are more regulated than transactions involving commercial properties, whether in connection with the sale, financing or lease of the same. There are more disclosure requirements on all parties involved (lenders, sellers, brokers and landlords) that change frequently.

11 Planning

How does your jurisdiction control or limit development, construction, or use of real estate or protect existing structures? Is there a planning process or zoning regime in place for real estate?

There is extensive legislation that regulates the land use, development and construction of real property, with multiple layers (federal, state, county and city). In California, much of the land use process is delegated to local agencies (counties or cities), which implement land use policies (typically in the form of general plans, specific plans and zoning ordinances), but development is still subject to state-wide regulations like the Subdivision Map Act and the California Environmental Quality Act (which are used at times to challenge developments).

12 Compulsory purchase

Does your jurisdiction have a legal regime for compulsory purchase of real estate? Do owners, tenants and lenders receive compensation for a compulsory appropriation?

In many jurisdictions, there is a concept called 'eminent domain'. It allows for the compulsory acquisition of private property. Property may be taken by the government or a third party with government approval for a public purpose, civic use and, in some cases, economic development. This includes government buildings, highways, railroads, public utilities and public safety.

When property is taken, the owner of the property is entitled to 'just compensation', which is the property's fair market value and what a willing buyer might pay for it. States vary on how they determine fair value.

When condemnation is possible, owners often hire attorneys to consider whether the property should be subject to eminent domain and whether the government is offering a fair price. Parties also often hire professional appraisers.

13 Forfeiture

Are there any circumstances when real estate can be forfeited to or seized by the government for illegal activities or for any other legal reason without compensation?

Real estate can be forfeited or seized by the government if it has been abandoned or if the government determines illegal activities have taken place on the property and seizes the property to stop those activities. The government can also seize property when it has been abandoned. Each state has its own rules on how it determines when the government can seize such property and how it is accomplished.

INVESTMENT VEHICLES**14 Investment entities**

What legal forms can investment entities take in your jurisdiction?
Which entities are not required to pay tax for transactions that pass through them (pass-through entities) and what entities best shield ultimate owners from liability?

A number of forms are recognised depending on the jurisdiction, including limited liability companies, corporations, partnerships, limited partnerships, trusts or individuals. Limited liability companies, partnerships, limited partnerships, tax-option (S) corporations and trusts not taxed at the entity level are all pass-through entities. Investors can use a combination of the above to shield themselves from personal liability. For example, a limited liability company may be formed with a limited partnership as its member or a limited partnership may be formed with a limited liability company as its general partner.

15 Foreign investors

What form of entities do foreign investors customarily use in your jurisdiction?

The choice of entity varies in part on the long-term plan of the foreign investor (that is, does the investor intend to flip the property or buy and hold the property, will the property be for the investor's own use or leased out to tenants, etc), as well as the residence of the investor or entity, as tax agreements and treaties vary from country to country. Many times foreign investors use a limited liability company to invest in real estate.

16 Organisational formalities

What are the organisational formalities for creating the above entities?
What requirements does your jurisdiction impose on a foreign entity?
What are the tax consequences for a foreign investor in the use of any particular type of entity, and which type is most advantageous?

Depending on the type of entity being formed (for example, limited liability company, corporation or limited partnership), counsel will frequently prepare the initial governing documents (articles, certificate of formation, operating agreement, shareholder agreement, etc) and filings with the appropriate secretary of state to establish the entity; however, ongoing legal formalities must be followed to ensure the corporate protections are preserved, about which counsel can guide the investor.

Foreign entities will be subject to the Foreign Investment in Real Property Tax Act of 1980 and possibly state-implemented tax regimes with respect to taxes and potential withholdings of sales proceeds and the International Investment and Trade in Services Survey Act with respect to certain reporting requirements.

ACQUISITIONS AND LEASES**17 Ownership and occupancy**

Describe the various categories of legal ownership, leasehold or other occupancy interests in real estate customarily used and recognised in your jurisdiction.

'Owning' real property typically refers to having a fee simple interest in the property (ie, an estate that continues forever and includes all fixtures, minerals and appurtenances). Lesser estates include ground leases (the right to use and possess the property for an extended term, frequently the right to build and own the buildings on the land during the term of the lease and the obligation to pay all costs associated with the land during the term, like taxes and insurance, such that the fee owner has no financial obligations during the lease term) and leases (the right to use and possess the property for a

finite period of time, with more restrictions imposed by the owner during the term regarding the use and development of the property). Fee simple interests can be owned 100 per cent by one party (individually or in an entity) or by multiple parties (for example, as joint tenants (equal shares), tenants in common (who can own in equal or unequal shares), community property (married individuals) or as the owner of a condominium with a shared right to common areas within the development). Ownership is typically transferred by the use of a deed. In California, the most commonly used deed to transfer property between unrelated parties is a grant deed, which transfers a fee simple estate, unless noted otherwise, and includes an implied covenant by the grantor that it has not transferred the same estate to any person other than the grantee and that the estate is free from any encumbrance made by the grantor. Other jurisdictions effectuate such transfers through such instruments as quitclaim deeds (also used in California, but less frequently in arms'-length transactions), warranty deeds and special warranty deeds.

Leases are customarily created through lease agreements, but unlike deeds, are not typically recorded, although in California a memorandum of lease may be recorded depending on the transaction. Other encumbrances such as covenants, conditions and restrictions, reservation of mineral rights, etc are typically recorded in order to put the world on notice of such rights and to bind subsequent owners of the property.

18 Pre-sale

Is it customary in your jurisdiction to execute a form of non-binding agreement before the execution of a binding contract of sale? Will the courts in your jurisdiction enforce a non-binding agreement or will the courts confirm that a non-binding agreement is not a binding contract? Is it customary in your jurisdiction to negotiate and agree on a term sheet rather than a letter of intent? Is it customary to take the property off the market while the negotiation of a contract is ongoing?

It is common for parties to agree on a non-binding letter of intent or term sheet before executing a binding contract of sale. This document identifies key business terms when preparing the binding contract.

If the document is identified as a letter of intent and states it is non-binding, courts generally will not enforce it. Courts understand the letter of intent is to bring the parties closer to completing a transaction, but making it non-binding means the parties have the right to not consummate the deal. Courts will not generally impose on the parties more than the non-binding agreement provides. Parties should consider the effect of a non-binding document before agreeing to it. Among the terms that are often included in a real estate deal is that the property will be taken off the market for a period of time so the parties are able to prepare a binding contract.

19 Contract of sale

What are typical provisions in a contract of sale?

Sale contracts normally include a description of the property (the land, improvements, any personal property, leases, service contracts, entitlements and other intangible property), the business terms (purchase price and deposits, which vary depending on the deal size and bargaining power), the inspection and escrow periods, the documents to be delivered at closing, the risk of loss, representations and warranties, restrictions on the seller until closing and any limitations on the parties' remedies.

In California, escrow companies typically handle the exchange of funds and documents. Because a buyer in California will obtain a title insurance policy from a title insurance company at closing, the seller is not legally required to make any representations regarding title to the property.

At closing, the utilities can frequently be read the day prior to closing. In California, at closing, the real estate taxes are normally prorated on an accrual basis, so each party pays the taxes allocable to its period of ownership.

Because the seller does not want the buyer to terminate the contract in the event of a casualty, many times the buyer may terminate the agreement only if there is a material casualty (ie, a casualty that requires substantial sums to repair or that allows a tenant to terminate its lease).

20 Environmental clean-up

Who takes responsibility for a future environmental clean-up? Are clauses regarding long-term environmental liability and indemnity that survive the term of a contract common? What are typical general covenants? What remedies do the seller and buyer have for breach?

Any party that owns contaminated property is in the chain of title and may be subject to liability. As between a buyer and seller, the parties can negotiate who is responsible for the clean-up. However, buyers are cautious to take on such liability due to the uncertainty of the costs and timeframe to complete any remediation, and a buyer's willingness to assume same frequently depends on the extent to which the purchase price is discounted and the availability of environmental insurance. If the buyer relies upon the seller to complete any remediation post-closing, there may be a holdback of the sales proceeds or guarantees from third parties, to satisfy any default of any clean-up obligation.

21 Lease covenants and representation

What are typical representations made by sellers of property regarding existing leases? What are typical covenants made by sellers of property concerning leases between contract date and closing date? Do they cover brokerage agreements and do they survive after property sale is completed? Are estoppel certificates from tenants customarily required as a condition to the obligation of the buyer to close under a contract of sale?

Because the value of a property is often tied to the tenancies and rents, it is customary for the seller to make a representation regarding the rent roll, any notices it has received from tenants regarding any defaults and any outstanding leasing commissions or improvement allowances. Buyers normally want the right to approve any new leases or amendments to existing leases until the closing occurs. Buyers and their lenders typically require the right to review and approve estoppel certificates (the form of which may be dictated by the lease or by the buyer's lender) from some or all of the tenants, depending on the size of the spaces being leased and the number of tenants.

22 Leases and real estate security instruments

Is a lease generally subordinate to a security instrument pursuant to the provisions of the lease? What are the legal consequences of a lease being superior in priority to a security instrument upon foreclosure? Do lenders typically require subordination and non-disturbance agreements from tenants?

A lease carefully prepared by ownership will make the lease expressly subject and subordinate to any present or future security instrument without the need for any further documentation. However, even with such a provision, lenders will normally require tenants leasing significant space at the property to execute and deliver a subordination, non-disturbance and attornment agreement, making the lease subject and subordinate to the lender's security interest in the property.

23 Delivery of security deposits

What steps are taken to ensure delivery of tenant security deposits to a buyer? How common are security deposits under a lease? Do leases customarily have periodic rent resets or reviews?

Unapplied security deposits are typically credited against the purchase price at closing and the buyer does not want any security deposits applied after the execution of the sale contract. The determination as to whether a security deposit is required in connection with a lease is a credit decision, such that national tenants may not have to pay one, while smaller tenants frequently must. If a letter of credit is in lieu of a security deposit, the buyer will want the seller to draw on same upon its request until the tenant has issued a new letter of credit in the buyer's name.

Rent resets in leases are not common, except in connection with fair market rent determinations in options to extend.

24 Due diligence

What is the typical method of title searches and are they customary? How and to what extent may acquirers protect themselves against bad title? Discuss the priority among the various interests in the estate.

In California, at closing, the buyer obtains a title insurance policy from a third-party title insurance company, insuring that the property is vested in the buyer, subject to certain exceptions to coverage, for which endorsements may be available to obtain affirmative coverage with respect to such exceptions. The title insurance company prepares its search of the public records based upon a 'plant' (ie, records it maintains).

Jurisdictions vary, but California generally follows the first in time, first in right system, such that interests in property are given priority based upon when they were created, but priority can be reordered by contract of such interest holders.

25 Structural and environmental reviews

Is it customary to arrange an engineering or environmental review? What are the typical requirements of such reviews? Is it customary to get representations or an indemnity? Is environmental insurance available? Is it customary to obtain a zoning report or legal opinion?

In commercial transactions, given the potential risks involved, many buyers will engage third parties, including environmental consultants, engineers and counsel, to perform environmental, property condition and zoning reports, which are in addition to any representations, warranties and indemnities the buyer may be able to negotiate from the seller in the sales contract. Environmental site assessments must be conducted in compliance with all appropriate inquiries under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), which are generally met by following the standards of the American Society of Testing and Materials (ASTM) 1527-2005.

26 Review of leases

Do lawyers usually review leases or are they reviewed on the business side? What are the lease issues you point out to your clients?

Legal counsel is routinely involved in reviewing leases and preparing abstracts for buyers and lenders, noting such things as any required estoppel certificate form, any termination rights for tenants, rights of first refusal or offer, any outstanding leasing commissions or tenant allowances, ensuring there is subordination language, if representing a lender, and confirming the business terms set forth in any rent roll (rent, security deposits, rent abatement, terms of lease, etc).

Property management agreements may be reviewed by counsel for the buyer and any lender and the lender will normally want any fees under the property management agreement to be subordinate to the lien and payment of the deed of trust.

27 Other agreements

What other agreements does a lawyer customarily review?

In commercial transactions, counsel will normally review the title report or commitment, together with any documents disclosed by such report or commitment, including any easements, covenants, conditions and restrictions and liens of record. Counsel will also typically review any brokerage agreements (at the onset of a transaction), as well as zoning reports and any surveys of the property to confirm any encroachments, the location of any easements, any potential setback restrictions, access, and compliance with parking requirements.

28 Closing preparations

How does a lawyer customarily prepare for a closing?

The attorneys prepare the closing documents to be signed by the parties (including the deed, assignment of leases and service contracts, bill of sale and notices to tenants regarding the sale), coordinate with the escrow officer, buyer, seller and any lender regarding the execution and delivery of all documents and funds, prepare closing instructions, assist with confirming any prorations and finalising the settlement statement and confirm the title insurance policy is acceptable and has the appropriate endorsements.

Lenders will require that all of the loan documents have been duly executed and delivered, and often require a legal opinion from the buyer's counsel, in addition to a lender's title insurance policy.

The escrow period varies depending on the particular deal, and, depending on the county, parties may be able to fund and record on the same day.

29 Closing formalities

Is the closing of the transfer, leasing or financing done in person with all parties present? Is it necessary for any agency or representative of the government or specially licensed agent to be in attendance to approve or verify and confirm the transaction?

In California, the closing is usually handled through escrow whereby the parties do not meet in person to sign and exchange documents, although in other jurisdictions, like New York, the parties may meet in person to sign and deliver the documents. Although certain documents, like the deed, must be notarised by a notary, generally no governmental agents need be present. In California, there is a transfer tax that varies from county to county and city to city that is due as a result of transfer.

30 Contract breach

What are the remedies for breach of a contract to sell real estate?

If a party fails to complete the purchase of real estate that has been agreed upon in a binding contract, the other party may file a 'specific performance' case to enforce the terms of the agreement. Depending on the facts, a court should enforce a party's binding obligation to purchase or sell property. In addition, standard real estate contracts provide that the prevailing party may recover its attorneys' fees in such litigation. It is important to have an experienced real estate attorney review the real estate contract before signing it to discuss what rights the parties may have if the sale is cancelled.

31 Breach of lease terms

What remedies are available to tenants and landlords for breach of the terms of the lease? Is there a customary procedure to evict a defaulting tenant and can a tenant claim damages from a landlord? Do general contract or special real estate rules apply?

It is common for a lease agreement to discuss the parties' remedies upon a breach, which will be enforced using general contract law.

If a tenant breaches a lease such as not paying rent, in California, as in many states, the landlord is required to give notice to the tenant. If the tenant still fails to pay rent, the landlord may file an eviction action, also known as an 'unlawful detainer'. In California, eviction actions are given priority in the courts. The tenant may defend the eviction by raising defences such as the tenant paid rent or that the property is uninhabitable and no rent should be due until it has been repaired. If the court finds the tenant breached and should be evicted, the tenant is required to vacate the property. If the tenant fails to vacate, the sheriff will assist in removing the tenant. Depending on the terms in the lease, the prevailing party may recover attorneys' fees from the losing party.

FINANCING**32 Secured lending**

Discuss the types of real estate security instruments available to lenders in your jurisdiction.

The most commonly used real estate security instruments are mortgages, in which the landowner's interest is mortgaged in favour of the lender, and the deed of trust, in which the landowner grants an interest to a trustee for the benefit of the lender. The law of the state in which the property is located determines which form is used, but in practice, the effect of the two instruments is similar. When the borrower's obligation is fully paid and performed, the mortgage is released by the mortgagee, and the interest granted under the deed of trust is reconveyed by the trustee to the landowner.

33 Form of security

What is the method of creating and perfecting a security interest in real estate?

Mortgages and deeds of trust must be recorded in local public real estate records to create a valid security interest in land. Generally, the order of recording will govern the priority of a security interest. A security interest in fixtures may be perfected in many states by including specific 'fixture filing' language in the mortgage or deed of trust or by recording a separate fixture filing.

34 Valuation

Are third-party real estate appraisals required by lenders for their underwriting of loans? Must appraisers have specific qualifications?

Institutional lenders normally require a formal appraisal performed by a licensed appraiser from an approved list; banks and other financial institutions are usually mandated under applicable law to obtain independent appraisals for new and modified real estate loans. Private lenders – particularly when relying on the credit worthiness of the borrower and guarantors rather than the value of the land – may use a more informal valuation of the collateral (such as an estimate of value by a real estate broker).

35 Legal requirements

What would be the ramifications of a lender from another jurisdiction making a loan secured by collateral in your jurisdiction? What is the form of lien documents in your jurisdiction? What other issues would you note for your clients?

Many states will allow a person to make an occasional loan secured by real estate without qualifying to do business in the state, and investors may usually purchase a loan made by a licensed or qualified lender without qualifying themselves; the interest in the underlying note should be transferred by endorsement or allonge, and the mortgage or deed of trust assigned to the new holder by a recorded assignment. The assignment would not normally incur new taxes, but would be subject to recording fees.

36 Loan interest rates

How are interest rates on commercial and high-value property loans commonly set? What rate of interest is unreasonably high in your jurisdiction and what are the consequences if a loan exceeds the reasonable rate?

Interest rates on real-estate secured loans are commonly based on a designated prime rate or one, two, three, six or nine-month LIBOR, but rates are often also based on interbank rates and various terms of US Treasury bonds, with spreads over the base rate ranging from zero to several points. Usury laws and exemptions vary from state to state. California, for example, caps interest rates at 10 per cent for consumer loans and at the greater of 10 per cent or 5 percentage points over a federal funds rate for all other loans, but there are many lenders who are exempt from this limitation, including banks, other financial institutions, insurance companies and licensed lenders. Other states offer exemptions for certain types of loans or for commercial borrowers. The penalty for usury also varies from state to state; in California, the penalty is three times the usurious interest.

For purposes of the usury statutes, interest includes loan fees, but does not typically include fees which are contingent, such as shared appreciation rights.

37 Loan default and enforcement

How are remedies against a debtor in default enforced in your jurisdiction? Is one action sufficient to realise all types of collateral? What is the time frame for foreclosure and in what circumstances can a lender bring a foreclosure proceeding? Are there restrictions on the types of legal actions that may be brought by lenders?

Judicial or non-judicial foreclosure is the primary remedy following default under a real estate secured loan. This is governed by state law and practice varies significantly from state to state, but the typical first step is written notice to the borrower that the debt is being accelerated due to default.

California allows a non-judicial foreclosure under the power of sale contained in the deed of trust, and the entire process can be accomplished in under four months; at the trustee's sale, the lender can 'credit bid' the amount of the debt, but most other bidders must appear at the sale with cash or a cashier's cheque. Typically, to limit liability and for other reasons, institutional lenders do not take the property in their own names, but instead form a subsidiary to hold foreclosed property.

California allows foreclosures of mixed real and personal property collateral to occur concurrently or in any order. Actions for a deficiency judgment are discussed separately below.

38 Loan deficiency claims

Are lenders entitled to recover a money judgment against the borrower or guarantor for any deficiency between the outstanding loan balance and the amount recovered in the foreclosure? Are there any limitations on the amount or method of calculation of the deficiency?

In California, a lender that chooses to foreclose non-judicially, under the power of sale, cannot obtain a deficiency judgment against the borrower. To preserve recourse to the borrower, the lender must file an action for judicial foreclosure; under that process, the court determines the 'fair value' of the property, and then enters a deficiency judgment for the difference between the lender's claim and the value of the property. A separate anti-deficiency statute applies to owner-occupied residential property and to deeds of trust held by sellers; except in rare cases, such as fraud, no deficiency judgments are allowed on these loans.

California also has a 'one action' rule which requires lenders to always look to the real property first. Seeking to recover funds

against the borrower, by setoff or other equitable remedies, or by judicial action, carries a sanction which may result in loss of the security interest. Loans secured by real property in several states, and loans guaranteed by persons who have primary liability under the note, such as general partners of a partnership borrower, create special issues for lenders under the one-action and anti-deficiency rules.

39 Protection of collateral

What actions can a lender take to protect its collateral until it has possession of the property?

Most forms of mortgages and deeds of trust allow appointment of a receiver following an event of default, and a court-appointed receiver is typically used by lenders to protect business assets, collect rents, and minimise loss and damage of the real property until the lender can obtain possession by foreclosure.

40 Recourse

May security documents provide for recourse to all of the assets of the borrower? Is recourse typically limited to the collateral and does that have significance in a bankruptcy or insolvency filing? Is personal recourse to guarantors limited to actions such as bankruptcy filing, sale of the mortgaged or hypothecated property or additional financing encumbering the mortgaged or hypothecated property or ownership interests in the borrower?

Except where anti-deficiency laws apply, recourse is a negotiable term. Loans with no recourse at all are rare, and most lenders will require recourse to the borrower or a guarantor at least in particular situations, such as waste, environmental damage, bankruptcy, skimming of rents or otherwise failing to apply rents, income and insurance proceeds to the expenses of the property.

41 Cash management and reserves

Is it typical to require cash management system and do lenders typically take reserves? For what purposes are reserves usually required?

Most lenders who set up a cash management or third party lockbox arrangement allow the borrower to control all cash (by daily sweeps into a borrower-controlled account) unless an event of default occurs, at which point the lender assumes control of the cash. The great majority of all loans do not have any cash management system, and for these the lender would most likely seek a receiver if the loan goes into default.

Depending on the condition of the property and the type of business conducted, lenders may require reserves to support a credit. Impounds for taxes and insurance are most common, and construction loans will usually include reserves for payment of interest as well as taxes and insurance. In non-construction loans, interest reserves are less common but may be required for a part of the term, particularly where cash flow has not yet been established.

Lenders often require a short term reserve, typically funded from the loan itself, for costs of repairs required immediately. For retail or office properties facing tenant turnover, many lenders will require a tenant improvements and leasing commissions reserve, usually funded from monthly deposits made by the borrower; these funds are typically not released until a new tenant has taken occupancy and accepted the space, as confirmed by an estoppel certificate.

Depending on the age and condition of the property, a lender may also require a capital improvements reserve, to be disbursed for improvements or repairs approved by the lender.

Most reserve accounts do not earn interest.

Update and trends

California Civil Code Section 1938 now requires lessors of commercial real property to make certain disclosures regarding whether or not the property being leased has undergone an inspection by a Certified Access Specialist, and, if so, whether the property has met all applicable accessibility requirements. Additionally, under AB

1103 (The California Nonresidential Building Energy Use Disclosure Program), owners of commercial buildings must start benchmarking and disclosing the energy consumption of such properties prior to the sale, leasing and/or refinancing of same.

42 Credit enhancements

What other types of credit enhancements are common? What about forms of guarantee?

Even where the value of the property and the cash flow generated are sufficient to support a loan, it is not uncommon for a form of credit enhancement to be required, most commonly in the form of a guaranty. Other forms, such as standby letters of credit or cash collateral, are less frequently used.

For construction loans, or loans secured by properties needing substantial and immediate renovation or repair, a holdback of funds sufficient to pay all costs of the work (up to the entire amount of the loan, after payment of interest and fees) is typical, with funds disbursed as work is completed. It is common for construction loans to have third-party payment and completion guaranties.

43 Loan covenants

What covenants are commonly required by the lender in loan documents? What is the difference depending on asset classes?

Loan covenants vary depending on the type of property, but generally will include maintaining insurance coverage, paying insurance premiums and real property taxes as due, maintaining the property in good order and repair, not transferring or further encumbering interests in the property or the borrower, and complying with applicable law, including disabled access requirements and environmental conditions. For retail, office and other leased projects, covenants often include complying with the landlord's obligations under leases, obtaining the lender's consent to new and modified leases and enforcing the tenant's obligations; where a property is operated under a franchise, such as certain restaurants or hotel properties, the covenants will include strict compliance with the franchisee obligations. Construction loans will normally include covenants to complete the project lien-free.

44 Financial covenants

What are typical financial covenants required by lenders?

Most loans include financial reporting requirements, at least annually but more frequently quarterly, and an underwriting requirement for a maximum loan-to-value ratio. Lenders often have the right to require subsequent appraisals, at the borrower's expense, but typically enforce that right only if there is an event of default or the loan is materially modified or extended. Other typical financial covenants may include a minimum debt coverage requirement or cash-flow requirements, or minimum net worth or liquidity requirements for the borrower or guarantor.

45 Bankruptcy and insolvency

Briefly describe the bankruptcy and insolvency system in your jurisdiction.

An automatic stay goes into effect once a case is filed, and acts as an injunction against creditors from taking most actions against property of the debtor. The injunction lasts until a bankruptcy court order lifting the stay has been entered or the stay has expired. The Bankruptcy Code recognises the concept of involuntary bankruptcy, which generally permits creditors holding the required amount and type of unsecured claims to force the debtor into bankruptcy by filing a petition for an order for relief. A trustee or debtor-in-possession (DIP) may, subject to court approval, assume or reject the debtor's executory contracts and unexpired leases within the statutory time period unless extended by court order. The automatic stay prevents a creditor from terminating the lease prior to the trustee's decision to assume or reject it, even if the debtor is in default on post-petition obligations (however, such a creditor may be entitled to adequate protection).

A business may reorganise under chapter 11 of the Bankruptcy Code, and a DIP has all the rights and powers, and shall perform all the functions and duties of, a trustee serving in a case.

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46 Secured assets

What are the requirements for creation and perfection of a security interest in moveable property? Is a 'control' agreement necessary to perfect a security interest and, if so, what is required?

Moveable property is subject to the Uniform Commercial Code, which has been adopted (with some variation) in all states. A security interest in most moveable personal property can be perfected by entering into a written security agreement (often combined with the mortgage or deed of trust where a loan is secured by both real and personal property) and filing of a form UCC-1 financing statement with the Secretary of State's office in the state in which an entity borrower is formed or in which an individual borrower resides, regardless of where the property is located. A control agreement is required for cash or financial assets unless those assets are actually in the possession of the secured party. Special rules apply to intellectual property.

47 Single purpose entity (SPE)

Do lenders require that each borrower be an SPE? What are the requirements to create and maintain an SPE? Is there a concept of an independent director of SPEs and, if so, what is the purpose? If the independent director is in place to prevent a bankruptcy or insolvency filing, has the concept been upheld?

Lenders often require that the borrower be a single asset entity, and specific covenants are included in the loan documents and sometimes in the organisational documents. Requirement of an independent director or springing member (whose vote is required to declare bankruptcy) is less common but not unusual. Lenders are increasingly allowing use of 'recycled entities', as long as only one asset is owned at a time.

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