



U.S. Real Estate Acquisitions

A Primer for the Non-U.S. Investor

As the U.S. real estate market continues its historic expansion, many non-U.S. real estate investors are looking at opportunities to invest in the United States. This brief article outlines important considerations for German investors in the acquisition process for U.S. real estate. Similar to other parts of the world, real estate acquisitions in the U.S. generally follow certain procedures and customs that have developed over time and vary to some extent based upon the U.S. state in which the property is located. The focus here is on acquisition procedures generally applicable across the United States, although knowledgeable counsel should be consulted in each instance.

SOURCING ACQUISITIONS

Certain foreign investors engage a U.S.-based real estate advisor to source potential transactions while others pursue transactions directly. Transactions may be off-market (also known as private), where the buyer is the only party negotiating for the acquisition. Alternatively, a property may be offered to the public through an auction process, where the seller has engaged a broker to market the property for sale to the strongest bidder.

REAL ESTATE ACQUISITION PROCESS

Letter of Intent

Once the seller and the buyer have agreed to enter into negotiations for the purchase and sale of a property, they will often negotiate a letter of intent containing the material terms of the transaction. The letter of intent generally sets out the material business terms for the acquisition, including pricing and timing. In the U.S., letters of intent are often legally non-binding upon the parties and demonstrate a mere indication of interest. Where circumstances allow, a buyer should seek exclusivity from the seller so that the buyer has the exclusive right to negotiate for the acquisition of the real estate for a certain period of time.

Purchase Contract

In a private off-market transaction, counsel for the seller will incorporate the agreed-upon terms contained in the letter of intent into a draft purchase contract. The purchase contract contains all of the rights and obligations for the parties with respect to the transaction and generally allocates risk and responsibility to one party or the other for any foreseeable events (e.g., the property burning down due to a casualty). The purchase contract also contains the schedule and



timeline for the events from the date of execution through the closing date. In a marketed transaction, the seller may provide a form of purchase contract to the final group of bidders in order to evaluate the bidders' comments to the purchase contract as part of awarding the deal.

Due Diligence Period

Upon execution of the purchase contract, the buyer often has the exclusive right to perform due diligence on the legal, physical and economic operations of the property. The typical due diligence time period in the United States is 30 days, although this time period may vary substantially based upon the competitiveness of the asset. The buyer typically deposits a portion of the purchase price (called the earnest money deposit) into escrow with a third-party escrow agent upon execution of the purchase contract. The buyer has the right to terminate the purchase contract during the due diligence period for any reason and receive a return of its entire earnest money deposit. Upon expiration of the due diligence period, the buyer no longer has the right to freely terminate the purchase contract for any reason and receive a return of its earnest money deposit. The return of the buyer's earnest money deposit after expiration of the due diligence period is subject to specific negotiated circumstances, such as a seller default, casualty or failure of a closing condition in favor of the buyer.

Due Diligence Materials and Data Room

The seller will often set up an electronic due diligence data room containing due diligence materials to be provided to the buyer about the real property and its operations. In a publicly marketed transaction, the data room would be available to bidders at the appropriate time during the marketing process.

In a private transaction, the data room will be made available as part of the purchase contract process. Care should be taken to identify at the outset of the transaction those due diligence materials that the buyer would like to review. The buyer may also ask for comfort in the purchase contract that it has access to all of the relevant due diligence materials about the asset. A seller may also make available due diligence materials on site at the property manager's office or in the seller's offices for review, and these materials are typically more ordinary due diligence items, such as tenant correspondence and historical files.

Title and Survey

The buyer will obtain a title commitment from a title insurance company that reflects the results of the title search conducted by the title company on the property to be acquired. The title commitment represents the title insurance company's commitment to issue a title insurance policy in the name of the buyer once the premium is paid and certain other conditions and requirements in the commitment are satisfied. The buyer's counsel must ensure that the title company is prepared to issue the owner's title insurance policy in the form required by the executed purchase contract at closing, and that all title issues are resolved prior to the expiration of the due diligence period. Upon payment of the premium for the title insurance premium on the closing date, the buyer obtains a final title insurance policy insuring its title to the property subject only to the agreed-upon permitted exceptions. To the extent the buyer obtains acquisition financing, the buyer will also be required to purchase a title insurance policy insuring the lien of the lender's security instrument.

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Consents, Waivers, Estoppels and Notices

Depending on the specifics of the transaction, acquisition of the real estate may require the prior waiver or consent of a party with a recorded right, such as: a right of first refusal or offer to purchase the property, or a beneficiary of a restrictive covenant encumbering the property. Without these consents or waivers, the buyer may be unable to acquire clean title or utilize the full operation of the property consistent with its present use. The form of the consents or waivers should be negotiated in advance of closing and be approved by the title company issuing the title insurance policy. The buyer of a multi-tenant commercial property often requires that tenant estoppels from all or a percentage of the tenants in the building be delivered at closing as a condition to the buyer's obligation to close. The form of tenant estoppel is usually negotiated simultaneously with the purchase contract. The estoppel certificates allow the buyer to confirm the rents and other material terms of the leases as well as the status of each tenancy.

Financing

Many times, buyers will obtain first mortgage acquisition financing in order to fund a portion of the purchase price on the closing date, particularly given that interest rates are near historic lows. The buyer should negotiate the terms of the financing concurrently with negotiating the acquisition with the seller so that the lender is ready to close upon acquisition of the property from seller. Generally, this requires the financing terms to be substantially completed as of the end of the due diligence period.

ACQUISITION STRUCTURE

Most often, institutional investors hold U.S. real estate in a special purpose limited liability company or limited partnership where the real estate is its only asset. Limited liability companies and limited partnerships are the preferred investment vehicles because of their flexible governance structures.

Delaware is the preferred jurisdiction of formation for these entities because of its well-developed laws on corporate

governance. To the extent the investor obtains non-recourse acquisition financing to fund a portion of the purchase, the lender may well require the use of a bankruptcy remote special purpose Delaware entity.

CLOSING THE ACQUISITION

Transfer of Underlying Property

Depending on the structure of the transaction, there are several different types of property that will be transferred at closing, including: land, improvements, any rights appurtenant to or affecting the land or improvements, leases, tangible personal property and equipment related to the real property, and intangible personal property, such as assumed service contracts, permits and licenses, warranties, guaranties, intellectual property, and business operations information associated with the real property. The scope and substance of the property to be transferred at closing is generally confirmed by the buyer during the due diligence period and varies by asset type. For example, the acquisition of an operating hotel involves significant personal property, as opposed to a single-tenant industrial property, which may not have any personal property associated with the real estate. Sellers transfer personal property through the delivery of a bill of sale in favor of the buyer at closing. Buyers should ensure through the purchase contract and due diligence process that they are acquiring all material personal property free and clear of any liens or encumbrances, as title insurance generally only covers the real property and not the personal property.

Lease and Contract Assignments

For real property subject to one or more leases, a seller will assign to the buyer all of the landlord's right, title and interest under the leases pursuant to an assignment and assumption of leases. The assignment and assumption of leases also should include the seller's interest in any lease guaranties or security deposits, which may be held in the form of cash or a letter of credit. When deposits are in the form of a letter of credit, all original letters of credit should be obtained by the buyer on the closing date, together with all documentation necessary to transfer or re-issue them to the buyer. Similarly, the buyer will take an assignment of certain service contracts at closing to continue the property operations with those vendors after

closing. The buyer typically reviews the contracts during the due diligence period and selects those contracts that it desires to assume. With respect to any contracts or agreements not being assumed by the buyer at the closing, the seller must generally terminate those agreements. The parties often negotiate who is responsible for the termination costs and post-closing expenses associated with terminated contracts that are not assumed by the buyer.

Closing Statement

The closing statement, sometimes called the flow of funds memo, is often prepared and finalized by the seller and the buyer just before closing to specify the exact amounts being settled through the closing. The closing statement reflects the apportionments that the parties agreed to under the purchase contract. These typically include: rent, including fixed rent and pass-through expenses or additional rent, other income produced by the property, tenant improvement allowances, free rent and other tenant incentives, leasing brokerage commissions, real property taxes and assessments, operating expenses (other than the cost of insurance), utility charges, any amounts prepaid under assumed contracts, and other costs customarily apportioned between parties related to the sale of property located in the same jurisdiction as the property. In addition to apportionments, the closing statement should include all the disbursements to be made at the closing by each party, including all third party costs and expenses incurred by each party which are required or elected to be paid out of the closing escrow. The seller customarily pays any commission due to the broker engaged by the seller to market the property.

CERTAIN TAX CONSIDERATIONS

Transfer Taxes

Many U.S. states, counties and cities impose taxes on the sale of real estate. More than two-thirds of the U.S. states currently impose transfer taxes, and the seller is more often liable for paying the tax, although the allocation may be subject to negotiation. The tax is due and payable upon submission of the deed for recording in the local land records in the jurisdiction in which the property is located. The taxation rate varies substantially across jurisdictions,

ranging from approximately 0.10% of the purchase price (which may be subject to an overall cap), to more than 2.5% in high transfer tax jurisdictions, such as New York City. In certain jurisdictions, the conveyance of ownership interests in entities that own real property – as opposed to the conveyance of the real property itself by deed – may be exempt from transfer taxes. This is the minority position, however, as most jurisdictions impose the same tax on the transfer of ownership interests in property-owning companies as they do on the transfer of an asset. Most of the jurisdictions that continue to have this distinction contemplate closing the loophole in order to increase revenue. Note that acquisition of an entity owning real property carries the potential for additional trailing liabilities beyond the scope of risks that are inherent in acquiring a property by deed.

FIRPTA

While tax considerations are generally beyond the scope of this article, non-U.S. investors should pay close attention to tax structuring prior to pursuing a real property acquisition. The Foreign Investment in Real Property Tax Act (FIRPTA) sets forth particular rules regarding the treatment of gains from the sale of certain U.S. real property. Foreign investors may be subject to FIRPTA withholding tax equal to 15% of the gross sales price. Some non-U.S. investors structure around FIRPTA through holding and selling an asset through the sale of shares in a real estate investment trust (REIT), which requires thoughtful planning and expert counsel.

This is just an overview of the real estate acquisition process in the U.S. Many opportunities are available in the current market, and German investors are advised to acquaint themselves with the structures for U.S. real estate investment in order to maximize the chances for a successful transaction.



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