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Real Estate

USA
Law and Practice
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Law and Practice

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Contents

1. General

1.1 Main Sources of Law

Real property is governed by the laws of the jurisdiction where the real property is located, which includes US federal law, the law of the state where the property is located, and the local rules and regulations of the particular county and municipality.

1.2 Main Market Trends and Deals

Despite some early concern, the real estate industry in 2019 continued to show strength and growth as the Fed's decision to lower rates three times in 2019 provided continued sources of financing. In addition, there was another year of strong capital influx, with investors looking for yield in the commercial real estate industry. The US real estate industry's continued growth was based on strong property fundamentals, economic growth, demographic growth and the demand for real estate investments from institutional investors. The multi-family, industrial and corporate office sectors all continued to show strong performances and rent growth, while retail continued to struggle given the growth of e-commerce. Finally, alternative investment classes such as data centres, senior living and medical offices remained a popular new investment strategy with investors.

1.3 Impact of Disruptive Technologies

Investors and developers have invested in proptech in an effort to improve overall efficiency in asset operations, but there has been no widespread use of blockchain in the commercial sales process, nor any use of other disruptive technologies in the real estate industry. Disruptive technologies are expected to continue to be discussed and evaluated, but no significant deployment and integration of these technologies is anticipated over the next 12 months.

1.4 Proposals for Reform

The EB-5 programme is undergoing significant changes and may become less utilised under the new regulations. While the programme is 30 years old, it has only been substantially utilised by real estate developers and investors for the past decade. The first major change is that the price of a US permanent residency visa through the EB-5 programme has increased by 80% (to USD900,000 or as high as USD1,800,000). As a result, demand for the visas has slowed significantly and the resulting use of EB-5 capital is decelerating. There was a rush to file applications before the new rules went into effect in November 2019, and activity since then has slowed dramatically. While the overall number of investors will likely drop in the short-term, overall dollar volume from EB-5 investments may remain significant because far fewer individuals are required to fund an investment. Under the new regulations, zones for EB-5 investment are designated by the federal government instead of the states. As a result, the new regulations tightened the geographical locations that are available for EB-5 investment in order to more specifically target those in need of economic stimulus.

2. Sale and Purchase

2.1 Categories of Property Rights

Property rights may be acquired in a number of forms, including fee simple ownership, possessory interests such as leaseholds, and non-possessory interests such as easements. The owner of a fee simple interest generally enjoys all aspects of ownership without limitation (subject to any public or private restrictions that may govern the property). Possessory interests such as space leases, ground leases, licences and life estates are more limited and temporary forms of property rights. The tenant holds a leasehold interest in the property for a certain length of time, while the owner continues to hold fee simple title. Easements are non-possessory interests in land that generally grant a non-owner the ability to enter property for a certain right of use, such as sidewalk usage within a retail project.

2.2 Laws Applicable to Transfer of Title

Laws governing the transfer of title to property vary by jurisdiction. In general, title to real property is conveyed by the execution of a deed that is recorded and indexed in the real property records of the county in which the property is located. In transactions involving the transfer of title to commercial property, including office, retail, multi-family, hotels or industrial projects, certain personal property is typically also conveyed by a bill of sale from the seller to the buyer. Generally, the form of conveyance within each state is promulgated by statute and is the same regardless of the type of real estate; however, many states require additional disclosures for residential property.

2.3 Effecting Lawful and Proper Transfer of Title

Almost all local governments maintain title registration offices where owners and lenders record various claims to real estate. A lawful transfer of title to real estate is accomplished by executing a deed and recording it in the applicable county in which the property is located. Recording and deed requirements vary in each jurisdiction and must be followed precisely.

Buyers of commercial property routinely purchase owner's title insurance, which generally insures the owner against any superior claims in the real estate based upon rights existing prior in time to the purchase.

2.4 Real Estate Due Diligence

Commercial real estate buyers typically perform physical, economic and legal inspections of the property. These inspections typically occur during a due diligence period, which may vary substantially depending on the type of asset and the circumstances of the transaction. Buyers will often engage third-party specialists to perform physical and environmental inspections of the property. Buyers generally also perform diligence related to the revenue stream of the property and the tenant leases, and a review of the zoning of the property. Buyers also conduct a title and survey review of the property.

2.5 Typical Representations and Warranties

Representations and warranties are some of the most heavily negotiated provisions in a real estate purchase contract, with few, if any, being provided by statute. In a sophisticated commercial transaction, sellers do not typically make representations and warranties with respect to items that the buyer can verify through diligence, such as the state of title or the physical condition of the asset. Most often, sellers will represent as to their authority to consummate the transaction, the existence and status of legal agreements affecting the property (such as leases and service contracts), the absence of defaults thereunder, the status of any litigation or claims affecting the property, and the absence of hazardous materials.

It is common practice to limit the buyer's remedies against the seller for a breach of representations and warranties discovered after closing, both by limiting the time in which the buyer may pursue the breach and by capping the amount of buyer recovery. Where a buyer discovers a material breach of a seller representation or warranty prior to closing, they can terminate the purchase contract and potentially recover damages for their pursuit costs.

Contract law and land use law are critical for investors to evaluate potential purchases of real estate. Buyers should review and understand all of the documents that affect the property, including leases, service contracts and documents recorded in the local land records that impose obligations or restrictions on the property.

2.6 Important Areas of Law for Investors

While there are many areas of law that are important for investors to consider when purchasing real estate, two areas that commonly create unforeseen consequences if not considered properly prior to a property's acquisition are the tax structure and treatment of an acquisition, and public and private restrictions applicable to the use and development of the property.

The US Federal Tax Cuts & Jobs Act contains several provisions relating to items such as tax rates, depreciation and expenses that have affected investment considerations in real estate.

The creation of Qualified Opportunity Zones has created a number of new projects in commercial real estate across the United States. However, only about one half of the number of funds that fund managers expected to raise for Qualified Opportunity Zone investments was successfully raised, and only about USD4.5 billion was raised by those funds versus the expected USD66 billion. While the programme did not meet the capital-raising goals that were initially considered, the Opportunity Zone Program did achieve its goal of spurring rehabilitation, repurposing and ground-up projects in many of the 8,000 low-income census tracts in the designated zones.

2.7 Soil Pollution or Environmental Contamination

The Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA) is the primary federal legislation governing events related to the exposure of real estate to hazardous materials in the US. CERCLA imposes strict liability upon "owners and operators" of real property for penalties and costs related to hazardous waste contamination and clean up. Strict liability means absolute legal responsibility for an injury imposed on a party without proof of carelessness or fault.

An owner that has not caused environmental contamination can limit its risk by following the US Environmental Protection Agency's interim guidance regarding safe havens for bona fide prospective purchasers and innocent land owners. To qualify as a bona fide prospective purchaser, one must perform "all appropriate inquiry" into the contamination status of the property prior to purchasing the property. This requires an investigation of the environmental condition of the property by a qualified professional documented in a written report, typically in the form of a Phase I Environmental Report.

2.8 Permitted Uses of Real Estate Under Zoning or Planning Law

A prospective buyer should confirm the permitted uses of a parcel of real estate under the applicable zoning or planning law by researching the designation of such property by the local zoning or planning office. In addition to reviewing the zoning regulations promulgated by the local authority, a prospective buyer can obtain a zoning report that summarises the property's compliance with the applicable zoning code.

If a proposed development is of significant value to a community, the applicable public authority may enter into development agreements with the developer, containing concessions and requirements with respect to the project.

2.9 Condemnation, Expropriation or Compulsory Purchase

Governments in the US have the power of eminent domain – ie, the right to take private property for public purposes. The Fifth Amendment of the US Constitution, which applies to the federal government as well as state and municipal governments, provides safeguards to protect property owners, including requiring compensation for any taking of property.

2.10 Taxes Applicable to a Transaction

State and municipal governments typically impose some level of taxes and/or fees with respect to the transfer of real property, but the scope and reach of such taxes and fees variy widely by jurisdiction. Many jurisdictions impose excise or stamp taxes (commonly called transfer taxes) at the state, county and/or municipal level that are determined based on the sale price of the property.

Whether transfer tax applies may depend on both the type of transfer (fee title versus lease) and the structure of a transfer (ie, a direct transfer or an indirect transfer through the transfer of the entity that owns the property). In some jurisdictions, the tax may only be imposed on the transfer of title to the property, while other jurisdictions may impose the tax on the transfer of a leasehold interest.

Certain jurisdictions only impose transfer tax on the direct transfer of real property, but not if the transfer is indirect – for example, where the entity holding title to the property does not change, but the ownership of that entity is transferred. In other jurisdictions, the tax is also imposed on indirect transfers of real property.

2.11 Legal Restrictions on Foreign Investors

Foreign persons are generally permitted to acquire US real estate, although the federal government imposes economic sanctions and restrictions that prohibit transactions with certain individuals, organisations and nations. The PATRIOT Act also requires certain disclosures related to the identity of foreign investors. Foreign investors should also be mindful of the requirements of the Bureau of Economic Analysis of the Department of Commerce, the Foreign Investment in Real Property Tax Act (FIRPTA), the Agriculture Foreign Investment Disclosure Act of 1978, and Department of Defense regulations, among others. Notably, in February 2020, the Committee on Foreign Investment in the US (CFIUS) implemented final regulations that expressly authorise the Committee to review controlling and non-controlling foreign investment in real property.

3. Real Estate Finance

3.1 Financing Acquisitions of Commercial Real Estate

Commercial real estate acquisitions – whether of a single property or a portfolio – are typically financed with mortgage and/or mezzanine loans. The economic terms of a commercial mortgage loan vary depending on the type of property, the intended development plan, the reputation and financial strength of the sponsor, and the course of the financing. The financing may be structured with fixed or variable interest rates, may be fully drawn at closing or provide for additional advances over time, and is typically non-recourse to the borrower other than certain "bad boy" carve-outs. As a non-recourse loan, the security for repayment of the loan is limited to the property and the borrower's other property-related assets.

3.2 Typical Security Created by Commercial Investors

Under a traditional mortgage loan, the borrower must provide the lender with a first-priority lien on the property as security for repayment. The lien is evidenced by a mortgage or similar instrument filed in the local public land records. Upon a default by the borrower, the lender's remedies include the ability to foreclose on the security instrument and either sell the property to a third party or obtain ownership and possession of the property directly.

The security provided in connection with a mezzanine loan is a pledge of the borrower's ownership interest in the property owner so that, upon foreclosure, the mezzanine lender is able to control the property by holding 100% of the membership interests in the property owner.

As additional security for a mortgage loan, the borrower is generally required to assign all property-related assets held by the borrower, such as all leases and rents and property-related contracts and agreements.

3.3 Restrictions on Granting Security over Real Estate to Foreign Lenders

While there are no general restrictions or prohibitions on granting security in US real estate to foreign lenders, the receipt by a US person of loan proceeds from a foreign lender and repayment of the same is subject to US anti-terrorism and anti-money laundering regulations.

Historically, CFIUS' jurisdiction was focused on mergers, acquisitions and takeovers of US businesses engaged in commercial activity, but CFIUS implemented new regulations in February 2020 that expand to also cover the purchase, lease or concession (including assets acquired out of bankruptcy) of US public or private property that (i) is in or functions as part of certain US air or maritime ports (ie, major passenger and cargo airports by volume, strategic commercial seaports, civil-military joint use airports), or (ii) is in close proximity to certain US government facilities.

In the February 2020 regulations, CFIUS published four lists of sensitive US government facilities, with the definition of "close proximity" depending upon the level of sensitivity (eg, property within the same county as a missile silo, within 100 miles of a fort, or within the territorial sea of an offshore base). Depending on the proximity test that applies, carve-outs exist for single-family homes, certain commercial or retail property, and/or US Census-designated "urbanised areas" or "urban clusters". In addition, CFIUS will only have jurisdiction if the foreign investor acquires at least three of the four following property rights:

- physical access;
- exclusion of others from physical access;
- improvement or development; or
- attachment of fixed or immovable structures or objects.

Notably, an acquisition of securities by a foreign person acting as a securities underwriter, in the ordinary course of business and in the process of underwriting, does not trigger CFIUS jurisdiction. A foreign lender to a US person for a purchase, lease or concession of US property – even if this creates a secured interest for the foreign lender – may not trigger CFIUS jurisdiction unless the foreign lender acquires equity-like rights or in the event of default.

3.4 Taxes or Fees Relating to the Granting and Enforcement of Security

In connection with the recording of any mortgage or other security instrument in the public records, the borrower will generally be required to pay various taxes and fees, such as intangible taxes, documentary taxes and registration fees. The amounts of such taxes and fees are often based on the loan amount (or portion thereof being secured by the applicable instrument), but the calculation will vary depending on the jurisdiction.

3.5 Legal Requirements Before an Entity Can Give Valid Security

Before an entity can deliver valid security over its real estate assets, it must be duly formed and validly existing in its jurisdiction of organisation and, if this jurisdiction is different to that within which the property is located, authorised to do business in the state in which the property is located.

The entity must also have insurable title to the property as evidenced by a title insurance policy insuring the priority of the lender's lien.

3.6 Formalities When a Borrower Is in Default

Generally, the loan documents will govern the enforcement of a lender's security interest in real property, subject to requirements and limitations of state law, such as notice to a defaulting borrower and other interested parties, public notice requirements prior to a foreclosure sale, and rights of redemption following a foreclosure sale. Upon foreclosure, lenders generally take title to the property free and clear of any properly noticed junior liens, but subject to any superior liens (eg, taxes).

3.7 Subordinating Existing Debt to Newly Created Debt

Existing secured debt may only become subordinated to newly created debt pursuant to an agreement among the parties, as the priority from recording the security instrument of the existing debt would have first priority over any newly created debt. Typically, in order to effect such a subordination, the debt holders would enter into a subordination agreement and/or an inter-creditor agreement.

3.8 Lenders' Liability Under Environmental Laws

Generally, a lender holding or enforcing security in real estate should not have liability under environmental laws; however, not all environmental legislation (eg, the Clean Water Act) contains protections for secured lenders, and secured lenders are generally not protected from third-party tort claims based on personal injury or property damage caused by environmental contamination. In addition, lenders who cause environmental issues or who exceed their role as a "lender" and act more like a property owner by participating in the management of the property (whether pre- or post-foreclosure) can be held liable under certain environmental laws.

3.9 Effects of Borrower Becoming Insolvent

Generally, the onset of a borrower's insolvency would not affect the validity of a security interest granted by the borrower in favour of a lender. However, the filing of any form of bankruptcy petition would automatically stay any proceedings initiated by creditors against the borrower, including any enforcement proceedings or real property foreclosure proceedings.

3.10 Consequences of LIBOR Index Expiry

With LIBOR anticipated to be phased out by the end of 2021, the key questions for borrowers are what future interest payments will look like and how interest rate products will be affected by the new reference rate replacing LIBOR. Borrowers should review existing (and new) credit agreements to determine if their loan's interest rate is tied to LIBOR and if there is a defined substitute. The borrower should discuss the substitute rate that the lender intends to use and when the interest rate will be calculated using the substitute rate.

With LIBOR anticipated to be phased out by the end of 2021, the key consequences for borrowers are what future interest payments will look like and how interest rate products will be affected by the new reference rate replacing LIBOR. Borrowers with loans having interest rates tied to LIBOR should review existing (and new) credit agreements to (a) examine the maturity dates to determine if the LIBOR expiry is applicable, and (b) determine if there are "fallback provisions" defining the new reference rate. If so, borrowers should analyse the impact if the new reference rate index used in the "fallback provisions" of the credit agreement became the actual interest rate. In the event that the changeover to the new reference rate could cause a potential material increase, borrowers should discuss proposed amendments (or revisions) to the loan with the lender.

4. Planning and Zoning

4.1 Legislative and Government Controls Applicable to Strategic Planning and Zoning

Local governments are typically responsible for strategic planning and zoning in their respective jurisdictions, and the degree to which local governments control the process differs tremendously. A variety of tools are used by local governments to regulate development, including special zoning districts, comprehensive plans, subdivision, site plans and unified development ordinances.

4.2 Legislative and Government Controls Applicable to Design, Appearance and Method of Construction

Building codes are typically used to create regulations regarding the method of new construction or refurbishment of an existing building. Building codes are expansive and contain varying requirements for different types of asset classes and uses. Jurisdictions often go beyond standard building codes and enact regulations for the design and appearance of new and refurbished buildings.

4.3 Regulatory Authorities

Local governments are typically responsible for regulating the development and designated use of individual parcels of real estate.

4.4 Obtaining Entitlements to Develop a New Project

The entitlement process varies by local jurisdiction. Generally, if the project or refurbishment is permitted under applicable use restrictions, the process would be administrative, with third parties not having the right to object to the proposed development. If the project or refurbishment is not permitted under the applicable use or zoning restrictions, then re-zonings, variances or amendments to the comprehensive plan are some of the typical processes that must be utilised in order to proceed with the desired development. This would usually require public notice and public hearings, during which third parties would have the right to object to (or support) the project.

4.5 Right of Appeal Against an Authority's Decision

A local government's decision regarding an application for permission for development or the carrying on of a designated use is subject to appeal in most jurisdictions. The specific right of appeal and related process will be specific to the jurisdiction. Typically, the right to appeal a decision related to a project that is permitted under the applicable use restrictions is narrow relative to a decision regarding re-zoning or amendments to a comprehensive plan. While the timeline for an appeal will depend on the jurisdiction and the decision being appealed, an appeal must usually be filed within 30 to 60 days of the initial decision. In many jurisdictions, courts follow the "fairly debatable" rule, whereby the court will not overturn a zoning decision that is supported by substantial evidence and was not made arbitrarily.

4.6 Agreements with Local or Government Authorities

Applicants often enter into agreements with local governmental authorities or agencies in order to facilitate a development project, whether required by statute or ordinance or merely as part of the approvals process for the development. In many cases, the local governmental authorities will condition approvals on the applicant agreeing to take (or to refrain from taking) certain actions. These agreements will bind the project and development either for a specific period of time or in perpetuity. For example, they may restrict the use of or require certain infrastructure improvements.

4.7 Enforcement of Restrictions on Development and Designated Use

Local governments have many different tools to enforce restrictions on development and designated use. During construction of a project, the local government may impose a fine on the developer/owner of the development or, in the case of a more severe violation, may issue a "stop work" order halting any construction on the site. Additionally, to the extent that performance bonds have been required for the project, the local government could trigger rights under any performance bonds, which would allow the local government to complete any outstanding requirements covered by the bonds. After completion of the project, the local government may bring a suit for specific performance or otherwise enforce any regulations through the courts.

5. Investment Vehicles

5.1 Types of Entities Available to Investors to Hold Real Estate Assets

Real estate investments in the US may be held in any type of legally recognised entity, but two types of entities are most frequently used: limited liability companies (LLCs) and limited partnerships.

LLCs have the liability-limiting characteristics of a corporation, such that the owners are not personally liable for the debts and other obligations of the company, but they are taxed as partnerships, meaning the income of the LLC is passed through to its owners before it is taxed. Also, LLCs have very flexible governance structures granting the owner(s) (or member(s)) wide latitude under the applicable LLC statute and, unlike a limited partnership, an LLC may have only one owner (known as the sole member), making it a particularly popular choice for individual investors.

A limited partnership is formed by one or more limited partners, who generally provide the source of capital for the partnership's operations (in this context, the investment in real estate), and a general partner that is responsible for the management of the partnership. Limited partnerships have two key features that make them popular for real estate investments. First, a limited partner is not personally liable for the partnership's debts and other obligations. Second, limited partnerships allow the income of the partnership to pass through to its beneficial owners before it is taxed. The main drawback of the limited partnership structure is that it requires at least two parties (the limited partner and the general partner), and the general partner is personally liable for the debts and other obligations of the partnership, although in practice the general partner itself is usually a type of entity, such as an LLC or corporation, that shields its beneficial owners from personal liability.

There are also other ownership entity types under US law that can be used, such as S corporations, C corporations, general partnerships or limited liability limited partnerships, although they are less common than LLCs and limited partnerships.

A real estate investment trust (REIT) is any entity that elects REIT status, which allows it to pass income through to its owners. REITs are creatures of the tax code and are subject to complex tax rules that require the advice of experienced practitioners. For certain types of assets and for investors with certain tax postures (particularly non-US investors), a REIT may provide significant tax advantages over a conventional investment vehicle.

5.2 Main Features of the Constitution of Each Type of Entity

Limited liability companies are governed by an operating agreement. Where an LLC is owned by a sole member, the operating agreement is typically a simple document that sets forth certain basic formalities. Because there is only one owner, full control of the entity as well as all of the economic benefits and burdens are vested in that owner, so there is no need to allocate control and economic rights. Where an LLC has multiple members, the operating agreement will often grant day-to-day control of the company to one member (known as the managing member), to an entity that is not a member of the LLC but is controlled by a member (known as a non-member manager) or to a board of members, but the other member or members will have the right to approve certain decisions. The scope of these approval rights is negotiated between the members. In addition to governance, operating agreements establish the priorities of economic distributions, procedures for calling additional capital from the members and rights for a member to transfer or otherwise exit the LLC.

Limited partnerships are governed by a limited partnership agreement, which allocates the management rights and responsibilities of the partners as well as their economic benefits and burdens. By definition, the general partner is tasked with the day-to-day management of the partnership. Consent rights and other rights of the limited partners to participate in the partnership are negotiated between the partners, as are their economic rights.

Corporations are formed by articles of incorporation and governed by their bylaws. These provide for, among other things, governance rights, capital raising, distributions and exit rights.

5.3 Minimum Capital Requirement

The costs of forming and organising an entity vary by state, but filing fees, annual registration fees and taxes typically amount to a few hundred dollars. Some states also require a minimum capital to be invested in entities. Regardless of whether or not an entity is formed in a state that requires the entity to be minimally capitalised, failure to capitalise an entity with adequate funds to operate for its intended purpose may expose its owners to personal liability, since this is a factor courts frequently consider in claims to pursue limited partners or members for the debts of a limited liability entity.

5.4 Applicable Governance Requirements

Limited liability companies typically provide a lot of flexibility in allocating management responsibilities. The management of a limited liability company can be controlled by one member (member-managed) or by a non-member manager (manager-managed). Management may also be vested in more than one member. Additionally, the operating company may establish a board of managers to manage the entity. The limited liability company agreement provides for the procedures related to governance of the entity, including frequency of meetings, elections and voting.

In limited partnerships, limited partners are generally permitted to have limited voting and control rights over the affairs of the limited partnership. Limited partnerships may have one or more general partners, who are responsible for managing the limited partnership.

Shareholders of corporations elect directors to the board that manages the corporation; however, state laws may require shareholder votes to approve certain matters. Additionally, the board of directors may appoint officers to manage the day-to-day business of the corporation.

5.5 Annual Entity Maintenance and Accounting Compliance

Entity maintenance and accounting compliance costs vary based on both the state of the entity's organisation and the state in which the property is located. Typically, states require an annual report and a filing fee of a few hundred dollars. Since most real estate investment vehicles are pass-through entities for US federal income tax purposes, most state income taxes are similarly passed through to the entity's owners. However, a few states impose franchise, income or similar taxes on pass-through entities. Corporations will pay state income tax in the states they are formed or operate if those states have an income tax. Accounting costs will vary based on the states in which an entity is formed and operates, as well as the nature of the entity and its assets and income.

6. Commercial Leases

6.1 Types of Arrangements Allowing the Use of Real Estate for a Limited Period of Time

Leases, ground leases, licences and easements are the most common agreements used to grant a right to occupy real property. Generally, leases differ from licences in two primary ways: first, the term of a licence is typically shorter than that of a lease; second, the grantor of a licence typically retains the right to revoke the licence, whereas early termination rights are less common in a lease. Ground leases typically grant the tenant the right to develop, construct and operate a building on the leased land during the term of the agreement, which is longer in duration than the term of a space lease.

An easement may also be used to grant a party use of a designated portion of another party's property for a specific purpose. While some easements are granted with unlimited duration, easements can also be used for limited time periods, such as providing access to a construction site until development is completed.

6.2 Types of Commercial Leases

Commercial leases can be broadly categorised based on the scope of economic and other responsibilities allocated to the tenant. This is typically based on the type of property being leased (multi-tenant v single tenant) and the duration of the lease.

Tenants under absolute net leases agree to assume the most responsibility. Under these agreements, the tenant is obligated to pay a base rent as well as all other operating expenses, including taxes, maintenance costs, insurance and utilities as well as the costs for any structural repairs that may be required during the lease term. Under a triple-net (NNN) lease, the tenant agrees to pay base rent as well as all or part of the property taxes, common area maintenance and insurance, while the landlord's responsibilities are typically limited to structural repairs. A double-net (NN) lease commonly provides that a tenant pays base rent as well as its pro rata share of property taxes and insurance, while the landlord is responsible for common area maintenance and structural repairs. Under a single-net (N) lease, the tenant pays base rent and its pro rata share of property taxes, and the other building expenses are the landlord's responsibility. Finally, under a gross or full-service lease, the tenant pays one rental amount per month, which includes the tenant's share of taxes, insurance and common area maintenance costs.

6.3 Regulation of Rents or Lease Terms

Lease terms in commercial leases, including rent, are generally freely negotiable.

6.4 Typical Terms of a Lease

Lease terms for commercial space are typically for a term of years. In some instances, a landlord and tenant may also negotiate for renewal options. Ground leases have longer terms, which allow the tenant to finance and develop the property as if it were the owner.

All leases typically require the tenant to maintain the leased space, including in many instances accepting responsibility for non-structural repairs in the leased premises. With respect to shared spaces, maintenance and repair obligations for shared spaces are typically placed on the landlord.

Alternatively, a single tenant of a property (including a ground tenant) is typically responsible for handling maintenance and repair obligations directly at its own cost.

Rent is generally paid on a monthly basis throughout the term. The first payment is often made at the beginning of the lease term, and subsequent payments are made in advance of the next lease month.

6.5 Rent Variation
Rent is negotiated prior to signing a lease, including any rent escalations during the term. Rents typically escalate on a percentage basis at intervals during a lease term. Additionally, any pro rata share of taxes and other charges paid by the tenant to the landlord may increase during the term as costs increase.

6.6 Determination of New Rent
Commercial leases may contain a schedule setting forth the amount of the base rent for each year of the lease term, or a formula to calculate the year-to-year changes in rent payable based on the applicable factors.

Additionally, many leases that provide an extension option by which the tenant can extend the term will provide for a determination of the fair market rent (often subject to third-party arbitration in the event of disagreement over the amount) to govern the extension terms.

6.7 Payment of VAT
Jurisdictions differ, but most states do not impose VAT on rent.

6.8 Costs Payable by Tenant at Start of Lease
Many leases require tenants to post a security deposit with the landlord, which may be gradually reduced or returned to the tenant over the term of the lease. Additionally, many landlords require the tenant to pay the first month's rent at lease signing.

If renovations or a build-out of the leased premises is required prior to occupancy, then the tenant will be responsible for the costs of this work unless the tenant negotiates for the landlord to provide a sum to be applied to these renovations.

6.9 Payment of Maintenance and Repair of Communal Areas
Common areas are usually maintained by the landlord, but at the cost and expense of the tenants. Depending on the lease structure, the tenants will either pay their pro rata share of the cost of common area maintenance in addition to base rent, or these costs and expenses will be included in an all-inclusive rent that accounts for these costs.

6.10 Payment of Utilities and Telecommunications
Most commercial leases require each tenant to contract and pay for the utilities and telecommunications serving that tenant's space, but utility costs for common areas of the building are typically allocated to, and paid by, all tenants on a pro rata basis.

6.11 Insuring the Real Estate that is Subject to the Lease
When a single tenant occupies an entire building and is directly responsible for the operating costs at the leased premises, it typically maintains insurance for the full replacement value of the building. In most other instances, the landlord will carry property insurance covering the full replacement value of the building. Whether or not the cost of the insurance is ultimately borne by the tenant will depend on the type of lease (ie, whether the lease is a double- or triple-net lease). Property insurance will typically cover all perils that damage a property, subject to certain exclusions and/or excluding specific perils (eg, earthquake or flood) that may be covered under separate policies.

6.12 Restrictions on Use of Real Estate
Landlords frequently restrict the uses of leased premises. Restrictions may be imposed to induce tenants to lease space by guaranteeing that competitors or incompatible users will not be operating in the building.

Land use and zoning rules and regulations may also impose use restrictions on a property.

6.13 Tenant's Ability to Alter and Improve Real Estate
Most leases require the tenant to obtain the landlord's consent prior to making any alterations or improvements to the premises. For substantial alterations, many leases will require the tenant to submit the plans and proposed contractor to the landlord for approval.

6.14 Specific Regulations
Residential leases are the most regulated type of leases. Laws and regulations vary by jurisdiction, but residential leases may be subject to rent control or regulation, health and safety requirements and laws that prohibit discrimination against individuals based on their sex, race, religion or national origin, for example. While commercial leases are generally not as heavily regulated as residential leases, they are subject to common law (including nuisance-related law) and zoning ordinances, among other rules and regulations that may vary by jurisdiction.

6.15 Effect of Tenant's Insolvency
Generally, a tenant's inability to pay rent will trigger a termination right on the part of the landlord. If the tenant files a petition for bankruptcy, it must typically assume or reject a commercial lease within 120 days of its bankruptcy filing, which timeline is subject to extension by the bankruptcy court. If the lease is rejected, the tenant will be forced to move out, but the landlord's claim against the tenant will be subject to bankruptcy protections, including an automatic stay on any lease payments. The bankruptcy process commonly lasts for multiple years.

6.16 Forms of Security to Protect Against Failure of Tenant to Meet Obligations

Many landlords require tenants to post a security deposit (in the form of either cash or a letter of credit) in order to enter into the lease. Additionally, the landlord may request a creditworthy guarantor to enter into a separate agreement to guarantee the tenant's obligations under the lease.

6.17 Right to Occupy After Termination or Expiry of a Lease

A tenant generally does not have a continuing right to occupy the premises once the term of its lease has expired, but it is important for landlords not to acquiesce in a hold-over to ensure that no new rights inure to the tenant. To deter tenants from remaining in a premises after the term, landlords typically impose significant rent on tenants who hold-over, and make the tenant responsible for all damages incurred by the landlord.

6.18 Right to Assign Leasehold Interest

Whether a tenant has the right to assign its interest in a lease or to sublease all or any portion of the applicable premises is negotiated between the landlord and tenant in nearly every lease. In most leases, landlords require a right to consent to any assignment or sublease, unless the tenant is assigning or subleasing to an affiliate. It is rare that a landlord will give a tenant a right to assign or sublease without the landlord having a consent right and/or imposing conditions. Typical conditions to an assignment or sublease include the following:

- the assignee or subtenant meeting a new worth requirement;
- the assignee or subtenant being bound by all terms and conditions of the lease, including those relating to the use of the premises;
- the assignee or subtenant (and any affiliate) not having filed for bankruptcy or similar protections; and
- in a sublease scenario, the subtenant agreeing to comply with all terms of the master lease, and to the fact that the sublease is subject and subordinate to the master lease.

The other significant issue that is negotiated in any assignment transaction is whether the assigning party (ie, the tenant) is released from obligations arising under the lease from and after the date of the assignment.

6.19 Right to Terminate Lease

Many leases provide that a material casualty, or the taking by eminent domain of a significant portion of the premises, will trigger a termination right for the landlord and tenant. Additionally, landlords may generally terminate the lease in connection with an uncured event of default by the tenant.

6.20 Registration Requirements

Each state has its own requirements relating to the formalities required for a lease to be effective – for example, some states require signatures to leases to be notarised or witnessed in order for the lease to be effective. Most states do not require leases to be recorded in the real property records in order to be effective; however, many tenants wish to record evidence of a lease in the real property records (typically in the form of a memorandum of lease), which protects the leasehold interest from the rights of certain parties, such as future buyers and lenders of the property. Nearly all states require nominal recording fees to be paid when recording a memorandum of lease, which are typically paid by the tenant, and a small number of states impose a transfer tax on leasehold interests; the amounts of those taxes vary depending on the term and value of the lease.

6.21 Forced Eviction

A court may force a defaulting tenant to leave by judicial action after the landlord brings a claim against the tenant. The timeline for a judicial action varies by jurisdiction, but eviction in many jurisdictions can take place in less than a month. Additionally, some jurisdictions allow the landlord to take "self-help" remedies to immediately evict the tenant, such as changing the locks.

6.22 Termination by Third Party

Where the government or municipal authority is not a party to a lease agreement, such authorities are not able to terminate a lease that was privately negotiated by other parties. However, a governmental authority could perform a taking of the real estate which is subject to the lease, thereby making the existence of the lease moot. The timeline governing the government authority's taking of the real estate would depend greatly on the government authority and real estate at issue.

7. Construction

7.1 Common Structures Used to Price Construction Projects

The most common pricing structures used on construction projects are:

- fixed price;
- reimbursable (cost-plus or time and materials); and
- unit pricing.

Under a fixed price structure, the parties agree to a fixed price for the completion of the work, with the contractor generally bearing the risk of project costs exceeding the fixed price.

In a reimbursable arrangement, the owner pays for the costs of construction on a reimbursable basis, and bears the risk of extra costs. Traditional reimbursable pricing structures can be coupled with a cap or guaranteed maximum price in a hybrid approach.

Unit pricing is an arrangement where payment is based on actual quantities at fixed unit prices.

7.2 Assigning Responsibility for the Design and Construction of a Project

Responsibility for the design and construction of a project is typically assigned through two primary delivery methods: "design-bid-build" and "design-build".

Under a "design-bid-build" arrangement, the engineer or architect is responsible for the design of the project. Once the design is completed, the owner will separately engage a contractor to assume responsibility for constructing the project as designed.

Under a "design-build" arrangement, the contractor also acts as the engineer and assumes responsibility for both design and construction.

7.3 Management of Construction Risk

Construction risks should ideally be borne by the party in the best position to control and mitigate such risks. Once identified, the risks can be managed or allocated among the project participants through risk transfer (eg, through indemnities) or risk assumption and reduction (eg, through a limit of liability).

These risk devices are not without limitation. Most states have enacted some form of "anti-indemnification" legislation that prohibits or limits the rights of parties to shift certain risks (eg, the sole negligence of a party). Similarly, a court will not enforce a limitation of liability in the event of wilful misconduct or fraud.

7.4 Management of Schedule-Related Risk

Schedule-related risks can be managed through a combination of schedule milestones, robust schedule and reporting requirements, recovery obligations, liquidated damages, early completion incentives, and clear contractual provisions addressing when extensions of time are allowed.

Damages due to a delay in construction are often difficult to estimate, so construction contracts frequently contain a liquidated damages clause that applies if a contractor fails to achieve certain milestones or completion dates. An owner should carefully estimate its anticipated damages in the event of delay, and ensure that the amount of liquidated damages both covers its anticipated damages and is enforceable against the contractor. Such anticipated damages may include lost profits, additional financing costs and extra owner costs, including additional overhead, rent and personnel costs. Courts will not enforce liquidated damages provisions that are deemed to constitute penalties.

7.5 Additional Forms of Security to Guarantee a Contractor's Performance

It is common for owners to require performance security from contractors, including payment and performance bonds, letters of credit, retainage and parent guarantees.

Bonds such as payment and performance bonds are typical in the construction industry. A performance bond protects an owner against contractor default by ensuring that the contractual obligations of the contractor will be fulfilled. Under a performance bond, the surety can either step in and perform the work if there is a contractor default, or it can pay the damages arising out of the contractor default. It is important to note that an owner should not anticipate that the surety will promptly perform or pay damages unless the default is clearly the fault of the contractor. In many cases, an owner will be required to sue the surety to recover damages, which may take years to collect.

A payment bond ensures that a contractor will pay its subcontractors for the work and materials provided. Similarly, if there is an issue, the surety will step in and pay the subcontractors.

A letter of credit is an instrument issued by a commercial bank that an owner may collect on upon demand of payment. It is not uncommon for owners to require a contractor to supplement a letter of credit with a parent guarantee or retainage.

Retainage is a common form of security that allows an owner to retain an agreed percentage of each invoice. It provides an owner immediate access to a pool of funds that grows over the course of the project and is released once the contractor satisfies its contractual obligations.

7.6 Liens or Encumbrances in the Event of Non-payment

Lien rights for contractors and/or designers are typically available. They are statutory in nature and require strict compliance with statutory requirements (such as timely notice and filing requirements) in order for a claimant to attach a lien to real property. Property encumbered with a perfected lien is subject to foreclosure to satisfy amounts owed.

An owner can remove a lien by successfully challenging its validity, by paying the debt or by obtaining a lien release from the claimant.

7.7 Requirements Before Use or Inhabitation

All states have requirements that must be met before a building can be inhabited or used for its intended purpose, with the procedure and requirements for certificates of occupancy varying widely from jurisdiction to jurisdiction. Generally, a certificate of occupancy describes the type of permitted occupancy, legal occupancy limits, layout, and allowable use of a building. A certificate of occupancy confirms that necessary paperwork has been completed, fees have been paid, violations (if any) have been resolved, the building complies with all applicable laws, and the plans and specifications have been approved by the local authorities.

8. Tax

8.1 VAT

Value-added tax (VAT) and sales tax are generally not imposed on the purchase or sale of real estate.

8.2 Mitigation of Tax Liability

A common technique to mitigate a real estate transfer tax is to sell equity interests of an entity that owns real estate, rather than transferring the real estate itself. Some jurisdictions, however, combat this technique by also imposing a transfer tax on the sale of a controlling interest in an entity with significant real estate holdings. Mortgage recording tax may be mitigated in some jurisdictions by the assumption of existing debt.

8.3 Municipal Taxes

Some jurisdictions impose special tax on business rentals. For example, New York City imposes a “commercial rent tax” equal to 3.9% of the gross rent paid for commercial premises located in certain parts of the city.

8.4 Income Tax Withholding for Foreign Investors

Income of foreign taxpayers is generally subject to one of two different taxation regimes. Income that is effectively connected with the conduct of a US trade or business (“effectively connected income” or ECI) is subject to taxation on a net basis at the same tax rates that apply to US taxpayers. Taxpayers who earn ECI or are engaged in a US trade or business, either directly or through a partnership or an LLC taxed as a partnership, are required to file a US tax return.

Foreign corporations are taxed at 21% on all ECI, while non-corporate taxpayers are taxed at up to 37% on ECI other than ECI that is treated as long-term capital gain, which is taxed at up to 20%. Under the 2017 tax reform legislation, certain “qualified business income” of non-corporate taxpayers qualifies for a special deduction of up to 20% of the amount of income, reducing the maximum effective rate to 29.6%. Rental real estate income generally constitutes qualified business income, provided that the level of activity associated with the rental income is substantial enough to constitute a trade or business, and that certain anti-abuse rules do not apply. The tax on ECI from real estate investment is generally not reduced by tax treaties.

Foreign corporations that have ECI may be subject to a second level of tax, called the “branch profits tax”, which is generally equal to 30% of the after-tax earnings from a US trade or business, reduced by earnings that are reinvested in US business property (but increased by earnings that are withdrawn from US investments). The branch profits tax may be reduced or eliminated by treaty.

Certain types of non-ECI investment income, including dividends, interest and rent, are subject to a flat, gross-basis tax of 30%, which is generally collected by withholding at source. This tax can be reduced by treaty, but existing treaties generally do not limit the taxation of income from real estate. Capital gain that is not ECI is generally free from US tax (subject to the provisions of FIRPTA described below).

Taxpayers whose real estate investments do not rise to the level of a trade or business may elect to treat the income from those investments as ECI, thereby escaping the 30% withholding tax in favour of the graduated tax on ECI. This election is frequently favourable for taxpayers, as it allows them to use deductions for interest, taxes and depreciation.

The Foreign Investment in Real Property Tax Act (FIRPTA) provides that gain or loss from the sale of an interest in US real property or a corporation whose assets primarily consist of US real property is deemed to be ECI, even if the gain would otherwise be capital gain not subject to US tax. Certain “qualified foreign pension funds” (QFPs) are exempt from FIRPTA.

The tax on ECI is enforced through three significant withholding taxes. First, any US partnership (including an LLC taxed as a partnership) that is engaged in a US trade or business must pay a withholding tax on any ECI allocated to a foreign partner, which is generally calculated at the highest tax rate applicable to that type of partner (ie, 21% for a corporation, or 37% for a non-corporate taxpayer). Second, a special FIRPTA withholding tax equal to 15% of the gross purchase price must be collected by a transferee of a US real property interest from a foreign transferor. Finally, a new withholding tax created by the 2017 tax reform legislation requires the transferee of an interest in a partnership that is engaged in a US trade or business to withhold 10% of the purchase paid to a foreign transferor. In certain circumstances where the required withholding is not made, the partnership may be required to pay the tax.

Many foreign investors in US real estate choose to invest through "blocker" corporations, which are separate taxpayers from their shareholders, and a shareholder is not considered to be engaged in a US trade or business solely as a result of owning stock in a corporation that is so engaged. As a result, shareholders of a blocker corporation may not be required to file a US tax return, nor to pay tax on their ECI. Capitalising a blocker in part with shareholder loans may improve the tax efficiency of a blocker structure.

A real estate investment trust (REIT) is a special type of blocker corporation. REITs must comply with numerous requirements for their organisation and operation, including restrictions on the nature of their assets and gross income. In return, REITs are subject to a special tax regime. Most notably, REITs can deduct dividends paid to shareholders from taxable income, which effectively eliminates the corporate-level tax on income that is distributed to shareholders. REIT dividends that are paid to foreign shareholders are subject to the 30% withholding tax, which may be reduced or eliminated by treaty.

Under FIRPTA, REIT distributions that are attributable to gain from the REIT's sale of a US real property interest are treated as ECI, and the shareholder must file a US tax return and pay the tax on ECI (including, for foreign corporations, the branch profits tax). QFPs are exempt from FIRPTA and are generally not subject to US tax on a REIT's distribution of sale gains. Gain from the sale of shares of a REIT that is majority owned by US investors is not subject to FIRPTA. Thus, it may be possible to avoid the FIRPTA tax on a REIT's distribution of proceeds from asset sales by selling the REIT's stock to a buyer.

8.5 Tax Benefits

Investments in US real estate benefit from certain tax advantages. For example, under the "like-kind exchange" rules, one real property investment can be exchanged for another on a tax-deferred basis, if certain requirements are met. Investments in buildings (but not land) can be depreciated over time, and real estate depreciation is generally not subject to the same "recapture" provisions (which treat certain sale gain as ordinary income) as personal property depreciation.

King & Spalding LLP has a Real Estate team composed of 27 partners and 40 qualified lawyers, with a national reputation for representing domestic and offshore investors in large-scale commercial real estate assets in the United States. The firm has represented clients in all major US markets (New York, San Francisco, Houston, Washington, DC and Chicago) in national marquee transactions over the past year. Its holistic, business-focused platform draws on the expertise of real estate partners, private equity partners, finance and restructuring partners, M&A partners and tax partners who constitute a team of dedicated, cross-disciplinary professionals with deep roots in the industry, regularly assisting clients with raising, structuring and deploying equity and debt capital in the public and private markets and completing real estate acquisitions, dispositions and developments with that capital. Other particular areas of focus include complex joint ventures, real estate funds, development and M&A, financial restructuring, public and private capitalisation strategies, domestic and cross-border tax structuring and Islamic finance.

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