The story so far

John L Opar and Lisa M Brill of Shearman & Sterling LLP give a mid-year report on the state of the United States' commercial real estate markets

A summary of today's commercial real estate markets is essentially the tale of two markets: Manhattan and Washington, DC (and perhaps a few other major metropolitan areas) on the one hand, and the balance of the United States on the other. The cities in the former primary markets have largely returned to pre-recession levels, with little remaining evidence of distress, capitalisation rates trending downward, and record-setting prices.

In each of these jurisdictions, sales agents are able to auction prime properties on a non-contingent basis – that is, bidders are required to complete their diligence pre-contract and commit to aggressive completion timetables, with no diligence or financing contingencies post-contract. Condominium conversions and new development in the residential, retail and office markets (including some speculative office construction) have also been sighted.

The story in the latter markets – effectively the balance of the US – is less positive. Hundreds of millions of dollars in loans secured by real estate remain in default, as a result of either non-payment of debt service or of loan maturities with no viable refinancing options. For loans held by a single lender or a syndicate, the options include reworking loan terms (what some in the market have pejoratively termed "extend and pretend") or taking ownership of the troubled asset. Variations on these themes are of course available, with some lenders bifurcating their loans into a smaller A-piece, more readily serviced by available cash flow, and a B-piece which offers some contingent recovery dependant on project performance or market turnaround.

Some trends from the downturn are prevalent, however, regardless of market. This downturn has seen less use by borrowers of the bankruptcy courts to facilitate restructuring. Some measure of credit undoubtedly goes to the prevalence of so-called bad boy guaranties and courts' general willingness to enforce guaranties that may expose a credit party to full repayment responsibility if the lender's efforts to recover on the asset are stymied.

In addition, loans packaged in commercial mortgage-backed securities (CMBS), once so popular, have foundered, as special servicers (identified to take over administration of troubled loans) have struggled with the complex tranching and intercreditor issues. The delinquency rate for securitised loans reached 9.889% in July 2011 (*National Real Estate Investor*, August 3 2011). The huge loan volume closed in 2006–2007 also represents a significant overhang on the market as those 5–7 year loans begin to come due.

The commercial real estate market is, of course, not unitary even within particular geographic areas. Multi-family has, for instance, remained perhaps the strongest throughout the downturn because of the continued availability of financing from Fannie Mae and Freddie Mac (despite their own difficulties) and a possible shift to rental housing because of the difficulties with home ownership amid the mortgage crisis. The hotel sector, always the first to suffer because of the essential daily adjustment to revenue sources, has, for the same reason, been a particularly strong investment target in the early days of the recovery.

Conversely, the long term nature of commercial office leases in the States (often 10 years or more) may well have deferred some of the impact of the economic downturn, but will likely delay full recovery

"First time investors will find the US legal system an unusual blend of the complex and the simple"

as well. Retail markets obviously have independent drivers, including demographics, the macro economy and the effect of technological innovation.

The legal environment

The US markets continue to attract capital from across the globe, with ever-increasing amounts of capital chasing a relatively modest amount of Class A product across property-type in the primary markets identified above.

First time investors will find the US legal system an unusual blend of the complex and the simple. The common law system predominant in the US has led to an inductive approach by which lawyers reason from a myriad of court decisions. This in turn has led to a level of complexity (and length) to legal agreements that will come as a surprise to investors from civil law jurisdictions, as the lack of precision inherent in the common law system leads lawyers to attempt, always without absolute success, to address as many scenarios as possible. A lease for New York office space, for example, can easily run to 75 pages.

On the other hand, first time investors are often equally surprised by the limited level of governmental regulation in the US system. No direct governmental approvals are required for ordinary transfers of commercial property or interests therein. Property operations do require a variety of governmental permits, but these are typically ministerial and not discretionary.

Private investment vehicles can be established same day, and flows of capital or profits are, subject to the decade-long concern with terrorist activity, largely unregulated. Similarly, the federal government, while reserving emergency powers on a variety of issues, has enacted little direct regulation of private real estate investment, notable exceptions being in the areas of consumer protection and condominium and land sales. The federal government has enacted some laws mandating reporting of US real estate investments, but these laws are primarily intended to enhance information flow to the government and not to directly regulate investment.

Laws regulating real estate transfers or investment are for the most part state-specific, but generally promote a relatively *laissez-faire* approach to commercial real estate investment. Sophisticated investors are thought to be capable of understanding complex financial transactions and protecting their own interests, though limitations can be imposed if contract provisions are thought to be penal in nature or violative of public policy.

Unlike many European jurisdictions, the US does not offer any official assurances with respect to title to real estate. Government offices have been established to accept the filing of documents transferring or affecting title to real estate. There is, however, no governmental certification of ownership.

An entire industry has, therefore, developed by which title insurance companies examine public records and prepare reports describing the state of title to a property. These reports can be converted into an insurance policy (essentially a form of indemnity protecting against claims to title accruing before the acquisition of the real estate) upon payment of a single premium.

Capital sources

Public real estate investment trusts continue to be active in the US markets, using corporate lines of credit and access to inexpensive public capital to fund acquisitions. Investment funds have also re-emerged as buyers, though fund raising has proven more challenging in the years since the downturn, with large investors requiring greater asset specialisation and less adviser discretion, and non-US investors being driven primarily by current yield.

With some narrow exceptions relating to farm land and other unimproved land, the US real estate markets have for many years been open to foreign investment. (Indeed, so few states have laws prohibiting commercial real estate acquisitions that such laws are not likely to prohibit foreign investment in commercial real property. Nonetheless, such laws should be reviewed before an acquisition by a foreign entity; a chart summarising alien land laws by state may be found in *Alien Land Ownership Guide – State Laws Relating to Ownership of US Land by Aliens and Business Entities*, National Association of Realtors, November 2006.)

The relative stability of the US markets, in particular the primary markets, the historic positive trend in capital appreciation, and the need to diversify from smaller or less stable domestic environments are all contributing factors in attracting foreign capital, including private investors and sovereign wealth funds.

Structuring of real estate investments can vary from the simplicity of an individual acquiring property through a single member (disregarded for tax purposes) limited liability company to complex multi-tiered joint ventures. While private investors normally opt for a partnership or limited liability company structure to avoid a second level of corporate tax and to facilitate the pass through of tax attributes, public real estate investment trusts have matured and are, as noted above, also an important source of investment capital.

Created in the early 1960s to facilitate retail (non-institutional) access to the commercial real estate markets, REITs use the so-called dividends paid deduction to achieve pass-through-like-tax treatment. Pension fund investors and non-US investors have also used private or warm body REIT structures to address concerns with unrelated business taxable income and to minimise the impact of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).

Tax treatment

Important changes in the tax treatment of real estate investment in the US date back to 1980's FIRPTA, which has had the effect of taxing most transfers of interests in real property (direct or through corporate transfers) at the same graduated rates applicable to US citizens. FIRPTA also provides for withholding by the purchaser of real property or shares of a company which owns

About the author

John Opar has been a member of the real estate practice group since joining the firm in 1980. He became a partner of the firm in 1989 and is currently the deputy practice group leader of the global real estate group.

Opar has extensive experience in all areas of commercial real estate law, including foreign investment in US real estate. He has represented public and private real estate investment funds and trusts, insurance company separate accounts and other investment vehicles.

He has also worked extensively on shari'ah compliant investment structures and has been involved in international real estate development projects in the Middle East, China, England, Germany and the Philippines. Opar has been selected for inclusion in Euromoney's *Guide to the World's Leading Real Estate Lawyers 2007*.

Contact information

John L Opar
Shearman & Sterling LLP

599 Lexington Avenue
New York, New York 10022
United States of America
t: +1 212 848 7697
f: +1 646 848 7697
e: jopar@shearman.com
w: www.shearman.com

real property from a foreign person. The withholding is generally imposed at the rate of 10% of the amount realised on sale. But the withholding can be reduced or eliminated by following specified procedures.

Notwithstanding the substantial impact of FIRPTA, there remain a number of techniques available to enhance tax efficiency. For instance, and unlike the treatment mandated by FIRPTA on transfers of realty, foreign lenders are not always subject to withholding tax on interest received. Loans qualifying as portfolio debt may enable an investor to achieve a better after-tax yield, although obviously capped at the interest rate payable. Inter-company debt not qualifying for portfolio treatment may still provide some state tax relief.

Financing availability

The financing markets have improved, but remain spotty. Balance sheet lenders are in the market, but can afford to be selective on location and project sponsorship. Loan-to-value ratios remain more conservative than pre-recession. Credit support is important, particularly for development financing. More conservative underwriting of project cash flows has also had the effect of reducing loan-to-value ratios.

Structured deals, with some mezzanine component, are proceeding, but not nearly with the complex tranching that was seen in 2007.

The CMBS market has rebounded somewhat, with 2011 volumes anticipated to be well above those of 2010, and 2012 forecast to be even stronger. That said, significant volatility in spreads has triggered recent concern. Indications that the rating agencies may be revising their criteria for rating CMBS have also put at least a short term damper on the market; long term implications are naturally hard to predict.

The regulatory framework for CMBS 2.0 also remains uncertain. While one would expect regulators to be interested in reinvigorating such a financing source, uncertainty remains. The risk retention requirements of Dodd-Frank (discussed in more detail below) have yet to be agreed, and limitations on the originators' right to sell the most profitable interest only piece has also generated concern.

Covered bonds have also received a fair amount of recent legislative attention, but there is little indication that they will have any significant impact on the financing market in the US.

> "With some narrow exceptions, the US real estate markets have for many years been open to foreign investment"

Recent regulatory developments

The real estate industry has by no means escaped the ire of state and federal regulators. While there is little direct regulation of ownership of real estate, there are regulations on lenders who make loans secured by real estate, primarily due to the number of distressed loans and the spike in home loan foreclosures in 2008 and 2009. Indeed, the first legislative responses came at the state level, as a dozen or more states have enacted legislation focused on residential home loans.

The most popular legislative responses have been to require pre-foreclosure notice periods and mandatory mediation and counselling (see Shearman & Sterling LLP Client Publication 'Legislative Response to the Residential Mortgage Crisis,' December 2008, which includes 'Insight For Investors: The New Residential Loan and Foreclosure Laws,' by John L Opar and Karen D Holdridge, *New York Law Journal*, November 24 2008). A few states have mandated automatic cure rights. Some state legislation may have longer term consequences as residential lenders have become subject to new underwriting standards and restrictions on loan terms thought to be particularly prevalent in the sub-prime market.

While much of the state legislation was enacted in the early days of the recession (2008), the federal government has jumped in with both feet with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. While rule-making continues, the SEC has finalised key rules to effect the overhaul of certain exemptions to federal regulation of investment advisors (see Shearman & Sterling LLP Client Publication 'Dodd-Frank Act Rulemaking: SEC Finalizes Exemptions and Disclosure Requirements for Investment Advisers and Sets Compliance for Early 2012,' July 12 2011).

Although real estate investment funds may not have been a primary target of the legislation, the elimination of the "counting clients" or "private-adviser exemption" from SEC registration has forced advisers to real estate investment funds to assess the availability of other exemptions.

About the author

Lisa Brill is a partner in the real estate group of Shearman & Sterling LLP. Brill first practiced in the firm's London office as a member of the capital markets group and later relocated to the New York office and joined the real estate group. She has significant experience in the representation of clients in the formation of joint ventures.

She also advises clients on many other areas of real estate law including acquisitions and dispositions, financings, real estate fund formation, leasing and hotel management agreements.

Contact information

Lisa M Brill
Shearman & Sterling LLP

599 Lexington Avenue
New York, New York 10022
United States of America
t: +1 212 848 4751
f: +1 646 848 4751
e: lbrill@shearman.com
w: www.shearman.com