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The Real Estate Finance Journal

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Fall 2024

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Scott J. Bent

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From the Editor

Robert G. Koen[*]

REITS!

By Robert G. Koen

This issue begins with several articles about real estate investment trusts, and then we have articles that discuss topics as diverse as sale-leasebacks to retainage on public and private construction projects.

AN INTRODUCTION TO REITS

The lead article in this issue is titled, "REITs Demystified: An Introduction to Real Estate Investment Trusts."

Here, Scott J. Bent of Frost Brown Todd LLP provides an overview of real estate investment trusts (REITs) and other common forms of real estate enterprises, followed by a discussion of several advantages and disadvantages of REIT status.

FIRPTA

Then, in the article titled, "Internal Revenue Service Releases Final Regulations Impacting FIRPTA Exemption for Domestically Controlled Real Estate Investment Trusts," Paige Anderson, Christopher Mangin, Jr., Ron G. Nardini and Paige Melton of Vinson & Elkins LLP discuss new regulations under Section 897 of the Internal Revenue Code of 1986, as amended, addressing when a real estate investment trust is considered domestically controlled.

TRANSFERABILITY REGULATIONS

In the article titled, "Final Transferability Regulations Address Real Estate Investment Trusts Issues," Paige Anderson, Christopher Mangin, Jr., and Sarah McIntosh of Vinson & Elkins LLP discuss new regulations that describe the treatment of eligible credits with respect to real estate investment trusts.

SALE-LEASEBACKS

The article that follows is titled, "Sale-Leasebacks: A Tool for the Times."

Here, Margaret S. (Meme) Peponis, Katherine R. (Katie) Reaves, Daniel C. Reynolds and Joseph Lanzkron of Cleary Gottlieb Steen & Hamilton LLP explain that although there are legal and accounting implications of sale-leaseback transactions, the ability to unlock the value of newly acquired (and sometimes long-held) tangible assets, while continuing to

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operate or utilize them, can be extremely valuable for businesses, particularly those that are struggling to find attractive debt financing or find themselves in volatile or high interest rate environments.

IMPACT FEES

Fawaz Bham and Javier De Luna of Hunton Andrews Kurth LLP submitted their piece, titled, "Navigating the Fee-nal Frontier of Impact Fees for Developments."

In this article, the authors discuss development impact fees, which are levied upon developers in connection with new construction or revitalization projects to offset the costs associated with increased demand for roads, schools, utilities, and other amenities necessitated by development.

DEEDS-IN-LIEU

The next piece, titled, "Recent Success in Dismissing Fraudulent Conveyance Claims in Deed-in-Lieu Transaction," is by Lisa Schweitzer, Daniel C. Reynolds, Joseph Lanzkron, Thomas Q. Lynch and Timothy Wolfe of Cleary Gottlieb Steen & Hamilton LLP.

Here, the authors review recent court decisions that are helpful to lenders in highlighting circumstances where courts are amenable to dismissing frivolous challenges to deed-in-lieu agreements in bankruptcy, notwithstanding higher appraised values and allegations of lender misconduct.

FINANCIALLY STRESSED TENANTS

The following piece, titled, "You Are a Landlord and Your Tenant Is Financially Stressed - What Should You Do?," is by Abbey Hone, Patrick L. Hughes, Abby Johanson, Rebecca Landau and Jeremy Herskowitz of Haynes and Boone, LLP.

As we all understand, tenant bankruptcy cases significantly impact landlords. In this article, the authors explore some of the issues that arise when a tenant is financially stressed and the potential mitigating actions from the perspective of the landlord.

A CALIFORNIA DEVELOPMENT

The article titled "California's Hotel and Private Residence Rental Reservation Refunds Law Is Now in Effect" is by Stacie Andra Goeddel and Samara Harris of Holland & Knight LLP.

In this article, the authors discuss a new California law that requires hotels, third-party booking services, hosting platforms and short-term rental locations to allow a cancellation without penalty for at least 24 hours after the reservation is confirmed if the cancellation is made at least 72 hours before check-in time.

GLOBAL REAL ESTATE GEMS

Next, Ronan McMahon a global real estate scout, discusses the benefits of various international real estate locations for investors. The title of his piece: "Exploring Global Real Estate Gems Amid Soaring U.S. Prices."

RETAINAGE

In "New York Could Further Limit Retainage on Public and Private Construction Projects," Adam J. Paterno, Timothy B. Froessel and David McNamara of Holland & Knight LLP, dis-

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acquisition, financings, and development; commercial project development; and real estate loan and investment workouts and restructurings. He may be contacted at koen@clm.com.

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cuss recent actions taken by New York legislators to further limit retainage in construction contracts.

REPORTING RULES

The next piece is titled, "Calling All Cash Money Millionaires: FinCEN Proposes New Reporting Rules for Cash Residential Real Estate Transfers." In this article, Warren Seay, Jr. and Rachel E. Collins of ArentFox Schiff LLP review proposed rules from the Financial Crimes Enforcement Network intended at increasing transparency in the domestic residential real estate market.

BUILDING SAFETY

James Kane and Bonny Hedderly of K&L Gates follow with their article, titled, "The U.K.'s Building Safety Act 2022: An Update." In this piece, the authors examine one of the United Kingdom's most comprehensive reforms of building safety legislation in the last 50 years.

WILDFIRES AND INSURANCE

Molly L. Okamura and Louis "Dutch" Schotemeyer of Newmeyer & Dillion conclude this issue with their article, titled, "Wildfire Risk Scores and Insurance Placement: What Property Owners and Developers Should Know," explaining wildfire risk scores and how they are calculated.

Enjoy the issue!

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REITs Demystified: An Introduction to Real Estate Investment Trusts

*By Scott J. Bent**

In this article, the author provides an overview of real estate investment trusts (REITs) and other common forms of real estate enterprises, followed by a discussion of several advantages and disadvantages of REIT status.

The real estate investment market teems with an alphabet soup of options - real estate investment trusts (REITs), real estate operating companies (REOCs), real estate mortgage investment conduits (REMICs), real estate private equity (PE) funds, master limited partnerships (MLPs), and so on. Each option has a unique profile of economic, legal, and tax characteristics, and one's choice among the available options can have great consequence. This article provides a brief overview of common real estate investment vehicles and discusses some objectives REITs are suited to achieve and others they are not. The scope is limited to investment vehicles fit for passive investors, so vehicles that require investors' active participation, such as many partnerships and joint ventures, are not addressed.

OVERVIEW OF INVESTMENT VEHICLES

This section surveys five common real estate investment vehicles:

(1) REITs;

(2) REOCs;

(3) REMICs;

(4) Real estate PE funds; and

(5) MLPs.

REITs, being the central focus, are covered in the greatest depth.

Real Estate Investment Trusts

A REIT is a business entity that is taxable as a corporation for federal income tax purposes and makes a valid REIT election with the IRS. REITs can take various corporate forms, such as corporations, business trusts, or limited liability companies, but most REITs are formed as Maryland corporations.[1] REITs must comply with a complex set of tax rules and regulations to maintain their status, with requirements governing such matters as the sources of the REIT's income, what it does with that income, the types of assets it holds, and much more. A REIT generally must dis-

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tribute (via dividends) at least 90% of its taxable income each year[2] and, unlike most C corporations, receives an income tax deduction for the dividends it pays,[3] thereby achieving modified pass-through status and avoiding double taxation. Certain types of income are excluded from "taxable income" for purposes of the 90% distribution requirement, including capital gains.

The pass-through status of a REIT is unlike that of other entities in several important respects. For example, unlike other pass-through entities, a REIT cannot pass losses through to its shareholders. Also, the dividends paid by a REIT are generally not eligible for the reduced tax rates for "qualifying dividend income," though under the Tax Cuts and Jobs Act (TCJA), certain REIT dividends qualify for a deduction of up to 20% for individual investors.[4] If a REIT retains any of its taxable income in excess of the 90% distribution requirement, the retained income is taxed at ordinary corporate rates. As such, most REITs seek to annually distribute 100% of their taxable income.

REITs are prohibited from acting as dealers in property, which means they may not sell inventory[5] to customers in the ordinary course of their business. Any transaction in violation of this prohibition is subject to a 100% tax on the net income realized. These rules help ensure that REITs remain true to their original purpose: serving as passive investors, like mutual funds for real estate, not property developers.

REITs are also subject to certain ownership restrictions. For example, there must be at least 100 shareholders,[6] and the REIT may not be "closely held," meaning the five largest individual[7] shareholders may not own more than 50% of the value of the REIT's stock.[8] The prohibition on being "closely held" is subject to look-through rules, which allow the REIT to look through most types of entities, including public charities, domestic pension plans, and profit-sharing plans, for purposes of the closely-held rules. The ownership restrictions imposed by the tax rules and regulations are reinforced by excess-share provisions in the charter documents of most REITs,[9] which prevent any investor from acquiring a large block of REIT stock.[10]

Investors typically contribute either cash or real estate in exchange for their interest in the REIT, and most REITs have a feature that allows investors to defer the income tax on their contributions of appreciated properties.[11] REITs often hold their investments through a limited partnership, commonly known as an "umbrella partnership," and the combined structure is known as an "umbrella partnership REIT" - or an UPREIT. The REIT serves as the general partner of the umbrella partnership, and investors may contribute real estate with built-in gain[12] to the umbrella partnership without triggering tax on the built-in gain. UPREIT investors do, however, incur income tax on their built-in gains when either (a) they exchange their limited partner interests for REIT shares, or (b) the umbrella partnership eventually sells the contributed real estate.[13]

REIT status offers unique benefits for tax-exempt investors that are subject to unrelated business taxable income (UBTI).[14] Such tax-exempt investors generally can use REITs to invest in leveraged real estate without incurring tax on UBTI, though REITs owned largely by pension plan investors are subject to

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special rules that can cause those investors to recognize UBTI.

REITs allow foreign investors to indirectly invest in U.S. real estate without incurring Foreign Investment in Real Property Tax Act (FIRPTA) tax on the gain from their sale of REIT stock, so long as the REIT is "domestically controlled," meaning less than 50% of the value of its stock is held directly or indirectly by foreign investors. Some types of foreign investors, such as sovereign wealth funds and qualified foreign pension funds, may benefit from REIT structures even if the REIT is not domestically controlled.

Most REITs are publicly-traded,[15] but some are privately held, and yet others register the offering of their stock with the U.S. Securities and Exchange Commission (SEC) under the Securities Act of 1933 but do not list their stock on any national securities exchange (often referred to as public non-traded REITs).[16] Publicly-traded REITs offer significant liquidity, as their shares can be readily traded on national securities exchanges. Privately-held and public non-traded REITs typically offer liquidity by allowing investors to sell their shares back to the REIT, commonly known as redemption rights, but such rights are usually subject to the REIT directors' discretion and the availability of sufficient cash.

REITs are required to hold primarily real estate assets and to generate most of their income passively from those assets. REITs typically own:

(a) Direct or indirect equity interests in real estate (equity REITs);

(b) Debt secured by real estate (mortgage REITs); or

(c) Some combination of equity and debt interests (hybrid REITs).

Many REITs focus on equity or debt interests in a certain sector of the economy, such as health care, hospitality, timberland, or data centers.

Real Estate Operating Companies

REOCs are similar to REITs in some respects; they invest in real estate, they often focus on one or more sectors, and they are predominantly publicly-traded. REOCs are not, however, subject to the complex rules and restrictions that apply to REITs, including the 90% distribution requirement. So, unlike a REIT, a REOC may retain an unlimited amount of its net income for reinvestment in the business, such as financing new acquisitions or capital improvements to existing properties. But the greater flexibility enjoyed by REOCs comes at a price - unlike REITs, publicly-traded REOCs are not pass-through entities, so they are subject to double taxation. The tax and economic characteristics of REOCs are generally suited for growth-oriented investment strategies, while REITs are primarily yield-oriented.[17]

Real Estate Mortgage Investment Conduits

A REMIC pools mortgage loans and issues mortgage-backed securities. Any type of business entity or trust can qualify as a REMIC, so long as it satisfies the statutory criteria and makes a valid REMIC election - though in practice, REMICs are typically formed as trusts. A REMIC is a pass-through entity, so income is taxed only at the investor level. Unlike mortgage REITs, REMIC interests typically are not publicly-traded.[18]

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Substantially all the assets of a REMIC must consist of mortgages secured by interests in real estate.[19] The mortgages generally must be transferred to the REMIC on the date it is formed or, under some circumstances, be acquired by the REMIC within three months of formation. Because REMICs must be fully funded not long after formation, they are largely inactive after funding. While REMICs resemble mortgage REITs in some respects, unlike REMICs, mortgage REITs may be actively managed and grow for an unlimited period.

REMICs may only have two types of ownership interests - regular interests and residual interests. Regular interests are similar to debt instruments in that they generally entitle their holders to payments of principal and interest, though some pay only principal and others only interest.[20] There are typically multiple classes of regular interests, known as tranches, with different maturities, coupons, payment priorities, risk profiles, and other features.

Residual interests, on the other hand, are like equity interests. Residual interest holders generally do not receive any payments until the regular interests have been fully satisfied, and they typically receive any assets remaining after the liquidation and termination of the REMIC. All residual interests must be of a single class and must pay distributions pro rata.

REMICs must comply with complex legal requirements to maintain their tax status. The requirements are largely meant to ensure that REMICs serve as a conduit for investing in mortgages and for no other purpose.

Real Estate Private Equity Funds

Real estate PE funds pool equity for investment in real estate deals, and they often focus on a particular property type, such as commercial or multi-family. The funds are created by sponsors who raise equity capital from passive investors and manage the enterprise. Real estate PE funds are often formed as limited partnerships, or limited liability companies structured like limited partnerships, and the sponsor is referred to as a general partner (GP), while the investors are referred to as limited partners (LPs). The GP uses the equity invested by the LPs along with debt capital to finance the acquisition or development of one or more real estate projects. Real estate PE funds are pass-through entities for income tax purposes.

There are generally five principal investment strategies employed by real estate PE funds, listed in order from lowest risk/return to highest:

(1) Core;

(2) Core-plus;

(3) Value-add;

(4) Opportunity; and

(5) Distressed or mezzanine debt.[21]

Strategies on the low end of the risk/reward spectrum generally have low or no leverage and tend to focus on well-occupied, stable, high-quality assets in primary or secondary markets. Investor returns on the low end of the spectrum predominantly consist of income yield rather than appreciation. Strategies on the high end of the spectrum tend to have moderate to high leverage and typically focus

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on assets in need of improvement or in distress. The higher up the spectrum, the more returns consist of appreciation rather than yield.[22]

The economic structure of a real estate PE fund is designed to provide an attractive return to LPs while rewarding the GP for its work and the heightened risk it assumes.[23] The LPs typically provide the vast majority of the equity capital, and the GP makes a relatively small capital contribution. The LPs usually receive a priority return of capital and a preferred return.[24] After the preferred return has been satisfied, the GP receives a percentage of profits significantly greater than its ownership percentage, typically ranging from about 15% to 20%. The GP's profits interest is commonly called a "promoted interest," a "promote," or a "carried interest." In addition to the promoted interest, the GP usually receives fees for a variety of services such as fundraising, managing acquisitions, asset management, and property management.

As the name indicates, LP interests in real estate PE funds are privately held and not publicly traded, so the interests may be sold only to certain investors and are subject to legal and contractual transfer restrictions. The general lack of a secondary market means that interests in real estate PE funds are highly illiquid, especially compared to publicly-traded vehicles like many REITs and REOCs.

Master Limited Partnerships

MLPs are limited partnerships that, unlike most partnerships, issue publicly-traded equity interests, typically called "units." MLPs were widely used as real estate investment vehicles during the 1980s and 1990s, but their use in the real estate space has greatly declined since. As of 2017, only about 3% of MLPs focused on real estate, and today they are used predominantly for investment in energy-related industries, especially midstream activities such as the transportation, processing, and storage of oil and natural gas.[25]

Like real estate PE funds, MLPs are managed by a GP, and the investors are referred to as "limited partners" or "unitholders." The GP's compensation often includes "incentive distribution rights," which are similar in some respects to the promoted interest held by the GP of a real estate PE fund.[26] Like REITs, unitholders generally invest in MLPs primarily for stable income yield rather than appreciation.[27]

MLPs are pass-through entities that are taxed as partnerships for income tax purposes. In order to maintain their pass-through status, however, at least 90% of their income must be limited to a narrow set of categories, including real estate rents, gain from the sale of real estate, and income and capital gains from various energy- and natural resources-related activities.

MLPs have several drawbacks compared to REITs, which likely contributed to their steep decline in the real estate space. For example, unlike REITs, MLPs can generate UBTI for tax-exempt investors. MLPs do not offer foreign investors the benefits provided by REITs. And, because MLPs are taxed as partnerships, the accounting burden is much greater for an MLP than a REIT.[28] For instance, each partner in an MLP may have a different tax basis in his or her share of the partnership property, so separate records must be maintained for each partner. Likewise, income tax preparation is

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generally more burdensome for limited partners of an MLP than for shareholders of a REIT.[29]

OBJECTIVES SUITED FOR REITS

The legal, tax, and economic characteristics of REITs make them uniquely suited to achieve certain business and investment objectives. For instance, if you want to form a vehicle for investment in real estate equity that is publicly-traded and avoids double taxation, a REIT is the clear favorite. As discussed above, MLPs could in theory serve this purpose, but they have several disadvantages compared to REITs, which perhaps explains why the use of MLPs in the real estate space has precipitously declined for decades.[30]

REITs lend themselves to certain asset classes and investment strategies. Given their inability to reinvest most of their earnings, REITs generally employ lower-risk strategies, such as core and core-plus, which focus on high-quality, stabilized properties with strong cash flow.[31]

Sponsors looking to create an evergreen vehicle for mortgage investments are better served by a mortgage REIT than a REMIC. While REMICs are generally closed off from acquiring new mortgages after three months from formation, mortgage REITs can acquire new assets and grow indefinitely.

REITs are primarily yield-oriented investment vehicles, thanks largely to the 90% distribution requirement, though they generally offer greater opportunity for long-term capital appreciation than some other yield-oriented investments like bonds.[32] REITs can also serve as a hedge against inflation, especially those focused on commercial properties, because rents under commercial leases often adjust upward with inflation.[33]

Certain types of investors may find REITs especially appealing. As discussed above, they offer tax-exempt investors a way to invest in leveraged real estate without recognizing UBTI, though this feature is little benefit to super-tax-exempt investors like state pension funds. REITs offer foreign investors a way to tax-efficiently invest in U.S. real estate. The UPREIT structure allows owners of appreciated real estate to diversify their holdings and access liquidity, all on a tax-deferred basis. Also, because of the simplified income tax reporting that comes with corporate status, REITs may appeal to certain individual investors who might not have the bandwidth or desire to handle the complex Schedule K-1s or the tax preparation burden that comes with most pass-through real estate investment vehicles.

An article recently published in the Yale Law Journal offers a new and interesting theory to explain the growth and popularity of REITs.[34] The theory centers on a fundamental income tax problem inherent in real estate investment: partners who contribute property with built-in gain[35] to a partnership have all the tax attributable to that built-in gain allocated to them when the partnership eventually sells the property. So, when a partnership sells a property with built-in gain, the partner who contributed that property participates in the profit from the sale pro rata while shouldering a disproportionate share of the income tax burden. This puts the interests of cash investors and property contributors at odds. According to the authors, REITs enable sponsors to effectively mediate these conflicting interests because the sponsor is largely insulated from investor

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pressure. Thanks to the prohibition on being "closely held" and the excess-share provisions in their charter documents, REITs are highly resistant to hostile takeovers, thereby sheltering the directors from the threat of activist investors who might try to pressure them to aggressively liquidate assets at the expense of property contributors.[36] Yet, hostile takeovers are important implements of modern corporate governance and accountability. The authors theorize that the requirement to distribute at least 90% of taxable income serves as a substitute for the possibility of a hostile takeover. In essence, REIT directors are given the insulation and independence to mediate conflicting investor interests, but they are held in check by their general inability to divert corporate earnings for self-serving purposes.

OBJECTIVES BETTER SUITED FOR OTHER VEHICLES

Every rose has its thorn, of course, and so it is with REITs. Some business and investment objectives are better left to other vehicles. For example, because REITs generally must distribute at least 90% of their taxable income, they are not appropriate for investment strategies that rely heavily on the reinvestment of earnings. Likewise, due to the 100% tax on sales of inventory, REITs are generally not suited for strategies involving the development or improvement of property with an eye toward resale. As such, sponsors engaged in property development and those who pursue value-add and opportunity strategies are generally a better fit for REOCs and real estate PE funds.

The pass-through status enjoyed by REITs is different from that of other vehicles, and the differences present certain limitations. For example, unlike most other pass-through entities, REITs may not pass through losses to investors. So investment strategies that involve generating deductible losses for investors are better suited for other pass-through vehicles like real estate PE funds.

A sponsor looking for the flexibility to invest in both real estate and non-real estate assets is generally not a good fit for a REIT, though, depending on the circumstances, a taxable REIT subsidiary (TRS) may fit the bill. A TRS is a subsidiary of a REIT that is taxable as a C corporation and is permitted to engage in certain activities prohibited for REITs. Otherwise, a REOC might work if double taxation is acceptable, and if not, an MLP may serve depending on the non-real estate assets involved.

REITs are complex, and with complexity comes cost. A sponsor planning to form a REIT must be prepared for the significant legal, tax, administrative, compliance, and other costs and burdens involved, which, if the REIT is to be publicly-traded, include the costs of going public. Sponsors that prioritize the minimization of such costs may want to consider other vehicles.

NOTES:

[1]A Theory of the REIT, by Jason S. Oh and Andrew Verstein, 133 Yale L.J. 755, 768 (2024).

[2]I.R.C. § 857(a)(1).

[3]I.R.C. §§ 561, 857.

[4]Without further legislation, the TCJA deduction will sunset after 2025.

[5]In this context, the term "inventory" means property owned or developed for the primary purpose of resale, as opposed to property held for a long term for the primary purpose of generating cash flow.

[6]I.R.C. § 856(a)(5).

[7]The term "individual" for this purpose includes natu-

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ral persons, private foundations, supplemental unemployment compensation plans, and charitable remainder trusts.

[8]I.R.C. § 542(a)(2), 856(a)(6), and 856(h)(1)(A).

[9]Oh and Verstein, 133 Yale L.J. at 769.

[10]Excess-share provisions often allow a REIT shareholder to exceed the applicable ownership percentage limitation if the shareholder obtains a waiver from the REIT's board of directors.

[11]Oh and Verstein, 133 Yale L.J. at, 787–788.

[12]The term "built-in gain" as used here refers to the unrealized gain in a property at the time it is contributed to an umbrella partnership. For example, if an investor has a $10 income tax basis in a property, and the value of that property is $100 when the investor contributes it to an umbrella partnership, the built-in gain is $90.

[13]As discussed in the section titled "Objectives Suited for REITs," the entire built-in gain that existed at the time of the contribution is generally allocated to the contributing partner when the umbrella partnership sells the contributed property, which places the interests of cash investors and property contributors at odds.

[14]UBTI is generally income earned by a tax-exempt entity that is not related to the entity's tax-exempt purpose (including, importantly, income from debt-financed real estate). UBTI is subject to income taxation. Some tax-exempt entities are not subject to UBTI, and they are commonly referred to as "super-tax-exempt." Examples of super-tax-exempt entities include integral parts of states and localities, as well as pensions for government employees.

[15]Oh and Verstein, 133 Yale L.J. at 812.

[16]Public non-traded REITs allow sponsors to raise capital from the general public without limitation as to the net worth or sophistication of the investor. Private REITs, on the other hand, are generally allowed to raise capital only from "accredited investors."

[17]Real Estate Operating Company (REOC) — Overview, How It Operates, Corporate Finance Institute: https://corporatefinanceinstitute.com/resources/commercial-real-estate/real-estate-operating-company-reoc/; Investing in Real Estate Investment Trusts (REITs), Charles Schwab: https://www.schwab.com/stocks/understand-stocks/reits; What's Right with REITs, Fidelity: https://www.fidelity.com/learning-center/trading-investing/investing-in-REITs; Guide to Equity REIT Investing, NAREIT: https://www.reit.com/what-reit/types-reits/guide-equity-reits; Real Estate Investment Trusts: Alternatives to Ownership, FINRA: https://www.finra.org/investors/insights/reits-alternatives-to-ownership.

[18]The CPA Journal, Tax Aspects of Investing in REITs and REMICs, Elizabeth Gurvits: https://www.cpajournal.com/2016/10/01/tax-aspects-of-investing-in-reits-and-remics/.

[19]I.R.C. § 860D(a)(4) and 860G(a)(3).

[20]Regular interests are also treated like debt instruments for income tax purposes.

[21]Creating a Private Equity Fund: A Guide for Real Estate Professionals, Jan A. deRoos and Shaun Bond: researchreportnaiop-creating-a-private-equity-fund-white-paper.pdf.

[22]Id.

[23]The risks assumed by the GP often include guaranties of indebtedness used to acquire or develop assets.

[24]A "preferred return" is the minimum return that LPs must receive before the GP can participate in the profits of the fund. It is often called a "hurdle rate."

[25]Master Limited Partnerships 101: Understanding MLPs, Master Limited Partnership Association: https://www.mlpassociation.org/wp-content/uploads/2015/08/MLP-101-MLPA.pdf.

[26]Id.

[27]Id.

[28]Real Estate Investment Trusts, by Micah Bloomfield, Evan Hudson, and Mitchell Snow. Chapter 1, Section 1:76.

[29]Limited partners in an MLP receive annual Form K-1s, which are generally more complicated than the Form 1099s received by REIT shareholders. The Form K-1 can be especially complicated and burdensome if the MLP owns real estate located in various states.

[30]Master Limited Partnerships 101: Understanding MLPs, Master Limited Partnership Association: https://www.mlpassociation.org/wp-content/uploads/2015/08/MLP-101-MLPA.pdf.

[31]Alternative Investments: The Case for Real Estate, Franklin Templeton: https://www.franklintempleton.com/articles/blogs/alternative-investments-the-case-for-real-estate; The Definitive Breakdown of REITs vs Private REITs, Aspen Funds: https://aspenfunds.us/breakdown-reits-private-reits/.

[32]What are REITs and How to Invest in Them, "U.S. News & World Report": https://money.usnews.com/investing/real-estate-investments/articles/the-ultimate-guide-to-reits; Guide to Equity REIT Investing, NAREIT: https://www.reit.com/what-reit/types-reits/guide-equity-reits; REITs vs. Bonds: Which are the Better Investment?, First National Realty Partners: https://fnrpusa.com/blog/reits-vs-bonds/.

[33]How REITs Provide Protection Against Inflation, NAREIT, Nicole Funari: https://www.reit.com/news/blog/market-commentary/how-reits-provide-protection-against-inflation.

[34]A Theory of the REIT, by Jason S. Oh and Andrew Verstein. 133 Yale L.J. 755 (2024).

[35]As explained in endnote 12, the term "built-in gain" as used here refers to the unrealized gain in a property at the time it is contributed to a partnership.

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[36]Shareholder activism in the REIT space has increased over the last decade. There have been very few hostile takeovers, but it is not unusual to see a transaction such as a merger or a spin off not long after an activist shareholder acquires a position in a REIT. See, e.g., Activists Seek REIT Renovations, Ronald Orol: https://www.thedeal.com/activism/activists-seek-reit-renovations/; Activists Are Now Knocking on the Doors of REITs, Moira Conlon: https://www.linkedin.com/pulse/activists-now-knocking-doors-reits-moira-conlon-1/.

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Internal Revenue Service Releases Final Regulations Impacting FIRPTA Exemption for Domestically Controlled Real Estate Investment Trusts

By Paige Anderson, Christopher Mangin, Jr., Ron G. Nardini and Paige Melton[*]

In this article, the authors discuss new regulations under Section 897 of the Internal Revenue Code of 1986, as amended, addressing when a real estate investment trust is considered domestically controlled.

The U.S. Treasury Department (Treasury) and the Internal Revenue Service (IRS) have released final regulations (Final Regulations) under Section 897 of the Internal Revenue Code of 1986, as amended, addressing when a real estate investment trust (REIT) is considered domestically controlled. With some modifications, the Final Regulations largely adopt the framework of the proposed regulations[1] (Proposed Regulations), although they do not address Proposed Regulations under Section 892 with respect to the foreign government exemption. The Treasury and the IRS indicated such proposals will be addressed in a separate rulemaking.

DOMESTICALLY CONTROLLED REITS

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) treats gain recognized by a foreign person on the disposition of a United States real property interest (USRPI) as income effectively connected with a U.S. trade or business and thus subject to the regular U.S. federal income tax.[2] However, Section 897(h)(2) provides that interests in a domestically controlled REIT are not USRPIs. Accordingly, gain recognized on the sale of shares in a domestically controlled REIT (DREIT) is exempt from FIRPTA. For a REIT to be domestically controlled, less than 50% of the value of its stock must, at all times during the specified testing period (generally a five-year lookback), be held directly or indirectly by foreign persons. Stated another way, more than 50% of a REIT's stock must be held by U.S. persons for it to qualify as a DREIT.

THE PROPOSED REGULATIONS

The Proposed Regulations provided rules for determining whether stock of a REIT is

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considered to be held "directly or indirectly" by foreign persons for purposes of determining whether such entity is domestically controlled. To determine the percentage of foreign ownership, the Proposed Regulations created the concept of "non-look-through persons" and "look-through persons." A non-look-through person includes individuals, most domestic C corporations, publicly traded partnerships, foreign corporations and estates. A look-through person is defined as any other person and includes REITs (except for certain publicly traded REITs), regulated investment companies, domestic and foreign non-publicly traded partnerships, and domestic and foreign trusts. In an exception to the general treatment of domestic C corporation as "non-look-through persons," the Proposed Regulations treated non-publicly traded domestic C corporations as "look-through persons" if foreign persons hold (directly or indirectly) 25% or more of the fair market value of the corporation's outstanding stock. This represented a significant change from practice prior to the issuance of the Proposed Regulations.

The Proposed Regulations also provided special rules applicable to persons owning shares in publicly traded REITs. Specifically, they provided that a person holding less than 5% of the stock of a U.S. publicly traded REIT at all times during the specified testing period would be treated as a U.S. person that is a "non-look-through person" with respect to that stock, unless the REIT has actual knowledge that such person is not a U.S. person. The Proposed Regulations also clarified that, except as described above in the case of a publicly traded REIT, a qualified foreign pension fund (QFPF) is a foreign person for purposes of determining whether a REIT is "domestically controlled," notwithstanding the QFPF's exception from taxation under FIRPTA.

The Proposed Regulations would have applied to transactions occurring on or after the date that the regulations are published as final regulations in the Federal Register. The preamble, however, noted that the Proposed Regulations could be relevant for determining whether a REIT is domestically controlled before the finalization date because the specified testing period for a transaction after the finalization date may include periods before that date. This sounded alarm bells for practitioners worried about the effect such a proposed applicability date could have on REITs that entered into structures with the expectation that whether a REIT is domestically controlled would be determined under the law existing prior to the issuance of the Proposed Regulations.

THE FINAL REGULATIONS

The Final Regulations became effective when published in the Federal Register on April 25, 2024 (the Effective Date). Although acknowledging comments requesting that the domestic corporation look-through rule be withdrawn, the Treasury and the IRS stated that they nonetheless believed it necessary to provide guidance regarding the meaning of "indirect" for purposes of determining whether a REIT is "domestically controlled." Further, the preamble to the Final Regulations emphasizes that the Treasury and the IRS are focused on whether there is "foreign control" of a REIT. However, the Treasury and the IRS agreed with commentators that this rule should be narrowed to address compliance concerns and more closely align the rule with the DREIT

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exception's focus on foreign control. As such, the Final Regulations increased the foreign-ownership percentage threshold for such corporations from 25% or more to greater than 50% (such corporation, a foreign-controlled domestic corporation).

The Final Regulations adopted the rule in the Proposed Regulations treating a QFPF as a foreign person for purposes of the DREIT exception without change. The Final Regulations also generally kept the rule treating shareholders owning less than 5% of a publicly traded REIT's stock as U.S. persons; however, the Final Regulations provide that this rule does not apply if the REIT has actual knowledge that such person is a foreign person or a foreign-controlled domestic corporation. The Final Regulations add similar exceptions to the treatment of public domestic corporations or publicly traded partnerships as "non-look-through persons" if the REIT has actual knowledge that the corporation or publicly traded partnership is foreign-controlled.

Importantly, the Final Regulations addressed significant concerns regarding the retroactive effect of the Proposed Regulations. Reversing course, the Treasury and the IRS determined that the domestic corporation look-through rule should be prospective in nature only.

Accordingly, the Final Regulations provide that, for a 10-year period, existing structures are exempt from the domestic corporation look-through rule, provided certain requirements are met.

Specifically, the 10-year transition period will end with respect to a REIT if either (1) the REIT acquires, directly and indirectly, USRPIs after the Effective Date with a fair market value of 20% or more of the fair market value of the USRPIs held directly and indirectly by the REIT as of the Effective Date, or (2) the REIT undergoes an ownership change such that the direct or indirect ownership of the REIT by "non-look-through persons" has increased by more than 50% in the aggregate as compared to the ownership on the Effective Date. With respect to the first of these rules, a REIT is permitted to use the asset values it uses for REIT testing purposes. With respect to the second, to simplify the ownership determination where the REITs is publicly traded, transfers by any person (regardless of their status as a non-look-through person) that owns less than a 5% interest in the REIT's stock will be disregarded, unless the REIT has actual knowledge of that person's ownership. If a REIT loses the benefit of the transition rule for either of the reasons stated above, the domestic corporation look-through rule will nonetheless be prospective only from the date the benefit of the transition rule was lost.

The Final Regulations also address uncertainty surrounding the procedures by which a DREIT may certify that an interest in its stock is not a USRPI and thus not subject to FIRPTA withholding tax upon disposition. Under Treas. Reg. §§ 1.897-2(h)(1), 1.1445-2(c)(3), upon request of a foreign shareholder, a domestic corporation must provide a statement of its determination as to whether its stock constitutes a USRPI. Section 1.897-2(h)(1) does not apply to DREITs, which resulted in uncertainty regarding the availability of such procedure to DREIT shareholders. In response to the uncertainty, the Final Regulations provide that while a DREIT is not required to do so, a DREIT may voluntarily provide a statement to its shareholders certifying that its stock is not a USRPI because the REIT is domestically con-

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trolled, which shareholders may furnish to transferees of their DREIT stock.

IMPLICATIONS

The Final Regulations provide much-needed certainty for structuring foreign investments in real estate following the issuance of the Proposed Regulations. Although somewhat narrower in scope than the Proposed Regulations, the Final Regulations solidify the approach of the Proposed Regulations with respect to determining whether a REIT is domestically controlled. While the addition of the transition rule provides comfort, REITs and other real estate industry practitioners should still carefully review their ownership structures to determine the impact of the updated domestic corporation look-through rule and verify any tax consequences for foreign investors.

Specifically, we expect the Final Regulations to have the following implications, among others:

- Practical end to "synthetic" DREIT structures on a go-forward basis;
- Challenges in maintaining the benefit of the transition rule with respect to DREIT structures that are not static (that is, structures in which the business plan contemplates continual capital raising and asset acquisition); and
- REIT shareholders negotiating to contractually require REITs to certify as to their domesticity under the "voluntary" procedures of the Final Regulations.

KEY TAKEAWAYS

- The government declined to adopt near-unanimous commentary on the proposed regulations recommending that the domestic C corporation "look-through" rule be withdrawn.
- For purposes of determining whether a REIT must "look-through" a domestic C corporation in testing for domestically controlled REIT status, the "25% or greater" threshold from the proposed regulations is increased to a "more than 50%" threshold in the final regulations.
- The final regulations impose an "actual knowledge" exception to treating publicly traded domestic C corporations as not subject to the "look-through" rule.
- The final regulations addressed retroactivity concerns by providing a ten-year transition rule for all REITs in existence as of April 25, 2024, pursuant to which (1) the "look-through rule" will not apply, and (2) application of the look-through rule is prospective only from the end of the transition period.
- The ten-year transition rule may end early for a REIT that acquires significant assets or undergoes significant changes in ownership.
- REITs may voluntarily certify, but are not required to certify, to their shareholders as to the REIT's "domestically controlled" status.

NOTES:

[1]See REG-100442-22.

[2]See Section 897(a)(1)).

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Final Transferability Regulations Address Real Estate Investment Trusts Issues

*By Paige Anderson, Christopher Mangin, Jr., and Sarah McIntosh**

In this article, the authors discuss new regulations that describe the treatment of eligible credits with respect to real estate investment trusts.

The Department of the Treasury and the Internal Revenue Service have issued final regulations[1] (the Final Transfer Regulations) regarding the transfer election for certain tax credits by eligible taxpayers available under Section 6418 of the Internal Revenue Code of 1986, as amended (the Code).[2] The Final Transfer Regulations specifically describe the treatment of eligible credits with respect to real estate investment trusts (REITs).

Although little was changed from the temporary and proposed regulations released in June 2023, the Final Transfer Regulations did provide two notable clarifications for REITs that hold eligible credits for transfer.

THE 75% ASSET TEST

In general, REITs are entities that own or finance income-producing real property in various industry sectors. Traditionally designed for investors who want to make passive investments in real estate, REITs are subject to various organizational and operating requirements under the Code. Among other requirements, at the close of each calendar quarter, at least 75% of the value of a REIT's total assets must be represented by real estate assets, cash and cash items (including receivables), and government securities (the 75% asset test). REITs are also subject to additional asset tests with respect to certain non-government securities that they hold, but those tests are beyond the scope of this article. A REIT is not subject to U.S. federal corporate income tax to the extent it distributes 100% of its taxable income to its shareholders. In general, REITs generate income by financing or leasing real estate and collecting rent or interest.

The Final Transfer Regulations provide that, with respect to the 75% asset test, REITs should not include the value of the eligible credit in either the numerator or denominator when calculating the percentage of qualifying assets in relation to the total assets. In other words, the eligible credits are disregarded for purposes of the 75% asset test and should not be included in either the total assets of the REIT or as a qualifying asset. The Final Transfer Regulations apply regardless of whether a REIT ultimately transfers the credits.

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THE PROHIBITED TRANSACTION SAFE HARBOR

REITs are subject to a 100% prohibited transaction tax on any net income derived from a "prohibited transaction." A prohibited transaction is a sale or other disposition of property held primarily for sale to customers in the ordinary course of the REIT's trade or business. A determination of whether a sale is a prohibited transaction is generally based on a facts and circumstances analysis. However, the Code provides a safe harbor for REITs pursuant to which a disposition will not be treated as a prohibited transaction. The safe harbor requires:

- The REIT to have held the property for at least two years;
- The aggregate expenditures includable in the basis of the property made by the REIT during the two-year period preceding the date of the sale do not exceed 30% of the net selling price of the property;
- Either (i) the REIT does not make more than seven sales of property, (ii) the aggregate adjusted bases of the property sold during the taxable year does not exceed 10% of the aggregate bases of all of the total assets of the REIT as of the beginning of the taxable year, (iii) the fair market value of the property sold during the taxable year does not exceed 10% of the fair market value of all of the assets of the REIT as of the beginning of the taxable year, (iv) (A) the aggregate adjusted bases of all such property sold by the REIT during the year did not exceed 20% of the aggregate adjusted bases of all property of the REIT at the beginning of the year, and (B) the average annual percentage of properties sold by the REIT compared to all the REIT's properties (measured by adjusted bases) in the current and two prior years did not exceed 10%, or (v) (A) the aggregate fair market value of all such property sold by the REIT during the year did not exceed 20% of the aggregate fair market value of all property of the REIT at the beginning of the year, and (B) the average annual percentage of properties sold by the REIT compared to all the REIT's properties (measured by fair market value) in the current and two prior years did not exceed 10%;
- The REIT to have held the property for at least two years for the production of rental income (in the case of property that consists of land or improvements); and
- If the seven sales requirement above has not been met, substantially all of the marketing and development expenditures with respect to the property to have been made through an independent contractor or a taxable REIT subsidiary.

The Final Transfer Regulations provide that if a REIT chooses to sell its eligible tax credits, the credit (or portion thereof) that is sold is not considered a "sale" for purposes of the prohibited transaction tax safe harbor. The preamble to the Final Transfer Regulations reasons that the sale of eligible credits should not burden the sales of real property by the REIT by counting such sales to the total number or dollar amount of sales permitted under the safe harbor.

The Final Transfer Regulations did not ad-

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dress whether the sale of energy for purposes of Sections 45 and 45Y would be considered a dealer sale under the prohibited transaction rules. Instead, the preamble directed taxpayers to analyze this issue on a facts and circumstances basis unless the scenario fits within the "net metering" safe harbor established by the preamble to the 2016 final regulations defining "real property" for purposes of the REIT asset tests.[3] The net metering safe harbor provides generally that a prohibited transaction will not result in any taxable year in which (1) the quantity of excess electricity transferred to the utility company during the taxable year from energy-producing distinct assets that serve an inherently permanent structure does not exceed, (2) the quantity of electricity purchased from the utility company during the taxable year to serve the inherently permanent structure.

IMPLICATIONS

The Final Transfer Regulations provide welcome certainty on asset test and prohibited transaction tax issues for REITs that desire to engage in energy credit transfers. As more REITs engage in energy efficient improvements at their properties, or even adopt an investment strategy focused entirely on renewables, their participation in the energy credit marketplace will be of increasing importance, and the Final Transfer Regulations will allow such REITs to do so without significant limitation.

NOTES:

[1]T.D. 9993, 89 Fed. Reg. 34770 (April 30, 2024).

[2]The transfer election was enacted as part of the Inflation Reduction Act of 2022 (the IRA), which provided that, for taxable years beginning after December 31, 2022, "eligible taxpayers" could elect to transfer all or a portion of certain tax credits to an unrelated taxpayer in exchange for cash. "Eligible taxpayers" are essentially all U.S. taxpayers that are not "applicable entities" as defined in Code Section 6417(d)(1), and include taxpayers that have U.S. employment tax or excise tax obligations even if they do not have a U.S. income tax obligation.

The tax credits generally eligible to transfer include: the alternative fuel vehicle refueling property credit (Code Section 30C); the production tax credit (PTC) (Code Section 45) for facilities originally placed in service after December 31, 2022; the carbon oxide sequestration credit (Code Section 45Q) for facilities originally placed in service after December 31, 2022; the zero-emission nuclear power production credit (Code Section 45U); the clean hydrogen production credit (Code Section 45V) for facilities originally placed in service after December 31, 2022; the advanced manufacturing production credit (Code Section 45X); the investment tax credit (ITC) (Code Section 48); the technology neutral ITC (Code Section 48E) and PTC (Code Section 45Y); the clean fuel production credit (Code Section 45Z); and the qualifying advanced energy projects credit (Code Section 48C).

The Final Transfer Regulations took effect 60 days after publication in the Federal Register (April 30, 2024).

[3]T.D. 9784, 81 Fed. Reg. 58960 (August 31, 2016).

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Sale-Leasebacks: A Tool for the Times

*By Margaret S. (Meme) Peponis, Katherine R. (Katie) Reaves, Daniel C. Reynolds and Joseph Lanzkron**

In this article, the authors explain that although there are legal and accounting implications of sale-leaseback transactions, the ability to unlock the value of newly acquired (and sometimes long-held) tangible assets, while continuing to operate or utilize them, can be extremely valuable for businesses, particularly those that are struggling to find attractive debt financing or find themselves in volatile or high interest rate environments.

A sale-leaseback is an arrangement in which a company sells an asset, such as real estate, vehicles or manufacturing equipment, and then immediately leases it back from the purchaser. The seller, which becomes the lessee, receives a lump sum payment but retains the rights to use the asset during the term of the lease in return for regular rental or lease payments to the buyer, which becomes the lessor. The economic terms of the lease are structured to be economically similar to those of a secured loan, with a portion of each rental payment including an implied financing cost, and the lessee typically has the right to acquire the leased asset. This implied financing cost is generally lower than the rate at which the seller/lessee could otherwise borrow, thus making these types of arrangements attractive to companies that already own or are acquiring tangible assets.

ADVANTAGES

A sale-leaseback transaction offers a company the ability to obtain cash proceeds to meet other business needs, such as building liquidity, paying down debt or making investments. In addition to the ability to raise capital at a relatively attractive cost (and often more capital in the aggregate than in a traditional financing secured by the same asset), sale-leaseback documentation may allow for greater operating flexibility than debt agreements that are based on the cash flow of the company, as they may not include change of control provisions or include covenants that regulate the operations of the lessee generally (just the specific assets that are subject to the lease arrangements). While the lease obligations are often treated as on-balance sheet, they can sometimes be structured as off-balance sheet operating leases for purposes of a lessee's debt agreements.

In addition, even if they are on-balance sheet and treated as financial debt for purposes of a lessee's debt agreements, such debt agreements may have specific exceptions

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that permit the capital lease obligations and may exclude them in calculating financial ratios.[1]

LEGAL CONSIDERATIONS IN DOCUMENTATION

There are a number of key legal considerations that companies need to consider before embarking on a sale-leaseback to the extent they have outstanding other debt agreements with restrictive covenants.

The lessee should consider the following in its debt agreements:

- Whether the agreements include a specific restriction on sale-leaseback transactions or similar restrictions through a restriction on asset sales;
- Whether the sale of assets in connection with the sale-leaseback would trigger a mandatory prepayment obligation or requirement to reinvestment the proceeds of the sale in a particular manner; and
- How the lease obligations will be treated for purposes of financial definitions under such debt agreements (e.g., interest expense), particularly those used in financial maintenance covenants (e.g., leverage ratios), and debt and liens covenants.

Negative covenants limiting asset dispositions (and mandatory prepayment triggers relating thereto) and the incurrence of debt and liens are typically relevant, and some debt agreements have negative covenants that specifically limit sale-leaseback transactions (often limiting them to transactions involving assets acquired within 270 days or limiting the amount of debt that can be incurred thereby) or counting them against otherwise available lien capacity.

Whether the debt and lien covenants are implicated (even if not specifically addressed by a company's financing arrangements) and how the lease obligation is treated in the financial maintenance covenants often depends on the accounting treatment of the lease obligations. Off-balance sheet lease obligations (or operating leases under older US GAAP) are often not treated as debt, while on-balance sheet lease obligations (or capital leases under older US GAAP) are likely to be treated as debt secured by an implied lien. Many debt agreements "hard-wire" the older US GAAP definitions as to the status of lease obligations, and thus it can be very important to consult accounting experts as to the characterization of the lease under the relevant accounting principles.

Sale-leaseback documentation often includes language whereby the lessee grants a security interest (i.e., a lien) in the leased assets to the lessor, as a precaution in the event the sale-leaseback arrangement is subsequently recharacterized as a secured loan by the courts in a bankruptcy or restructuring proceeding.

In the event of such recharacterization, the lessee would be deemed to have retained its ownership of the assets and the lessor is treated as a secured lender. It is important that any such lien provision not be overly broad such that it would encompass assets that are not, in fact, subject to the sale-leaseback and that any such precautionary lien is released upon the termination or expiration of the lease.

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SUMMARY

While there are legal and accounting implications of sale-leaseback transactions, the ability to unlock the value of newly acquired (and sometimes long-held) tangible assets, while continuing to operate or utilize them, can be extremely valuable for businesses, particularly those that are struggling to find attractive debt financing or find themselves in volatile or high interest rate environments.

NOTES:

[1]The actual tax and accounting treatment of a sale-leaseback requires a complex analysis made by accounting and tax professionals, and is in any event outside of the scope of this article.

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Navigating the Fee-nal Frontier of Impact Fees for Developments

*By Fawaz Bham and Javier De Luna**

In this article, the authors discuss development impact fees, which are levied upon developers in connection with new construction or revitalization projects to offset the costs associated with increased demand for roads, schools, utilities, and other amenities necessitated by development.

Development impact fees are a common tool used by local governments to fund public infrastructure and services, which play a crucial role in the process of urban and suburban growth. These fees are levied upon developers in connection with new construction or revitalization projects to offset the costs associated with increased demand for roads, schools, utilities, and other amenities necessitated by development. In other words, they are used to soften the "impact" that the new development is going to bring to the infrastructure already in place.

While development impact fees may sometimes lead to debates between developers and local governments, there is an argument that they can pose entry barriers for developers and contribute to challenges in maintaining the affordability of housing and commercial properties in expanding areas. On the other hand, proponents of impact fees assert that they are instrumental in promoting fair cost-sharing and ensuring that communities can support new growth in a sustainable manner.

RECENT SUPREME COURT DECISION: *SHEETZ V. COUNTY OF EL DORADO, CALIFORNIA*

A recent U.S. Supreme Court decision, *Sheetz v. County of El Dorado, California*, has brought development impact fees to the forefront of discussion by answering the question of whether the "*Nolan/Dolan*" test (based on U.S. Supreme Court precedent) used to evaluate the potential abuse of the permitting process, also extends to monetary fees imposed by legislative action.

The case arose from a dispute between a real estate developer, Sheetz, and the County of El Dorado, when the county required Sheetz to pay a "traffic impact fee" amounting to $23,420 as a condition to receiving a residential building permit. This fee formed part of a broader "General Plan" established by the county's board of supervisors to address escalating demands for public services spurred by new developments. However, the fee's calculation did not directly correspond to the costs of traffic impacts specifically linked to

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Sheetz's project. Instead, it was determined based on a rate schedule that considered the type of development and its location within the county.

While courts had differing views on whether to apply the *Nolan/Dolan* test to legislatively prescribed monetary fees such as impact fees, the U.S. Supreme Court has now resolved the issue.[1] The Supreme Court held unanimously that the *Nolan/Dolan* test applies uniformly to all impact fees and permits, regardless of whether they were being imposed on a discretionary basis or due to legislative action. Which means that in order for a development impact fee to be constitutional, such fee must have: (i) an "essential nexus" to the government's land use interest, and (ii) a "rough proportionality" between the project's actual impact and the fees being imposed.[2]

It is important to note that local governments commonly use reasonable formulas or general plans that assess the impact of classes of development rather than the specific project for a variety of reasons, such as lack of resources, lack of expertise, or expediency demands. In his concurrence, Justice Kavanaugh, joined by Justices Kagan and Justice Jackson, emphasized that the "decision does not address or prohibit the common government practice of imposing impact fees, on new developments through reasonable formulas or general plans that assess the impact of classes of development rather than the specific parcels of property."[3] The decision left that question open, noting that no prior Supreme Court decision has addressed or prohibited this longstanding government practice.

CRITERIA FOR ASSESSING AND SATISFYING THE *NOLAN/DOLAN* TEST

As a result of the ruling in the *Sheetz* case, local governments and developers must now consider the following elements to assess and satisfy the *Nolan/Dolan* test:

1. *Essential Nexus*: This element requires a clear connection between the fee imposed and the government's interest in land use. Local governments must demonstrate that the fee addresses a specific impact of the development project. For example, a traffic impact fee should directly correlate with the increased traffic generated by the new development.
2. *Rough Proportionality*: The fees imposed must be proportional to the actual impact of the development. This involves a detailed analysis to ensure that the fee amount is not excessive and is directly related to the development's impact. For example, a development project that is expected to increase traffic by 10%, should have an impact fee that reflects the cost of mitigating that 10% increase.

It is worth noting that the application of the *Nolan/Dolan* test will vary greatly depending on the facts of each case and the attributes of the impact fee in question. Courts will examine the methods local governments use to calculate the impact of a development and assess whether the capital improvements funded by the fees share a nexus and are proportional to the development that is going to be built. While there are several factors which courts tend to analyze when reviewing proportionality and nexus of impact fees, it is important to note that no single factor is decisive and that

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the analysis will be comprehensive. However, the following factors may raise red flags as to whether the impact fees imposed are unconstitutional:

1. *Buy-In Fees*: When the fee imposed by the local government is based solely on anticipated developments or the expectation that future residents and businesses will need better infrastructure, it could be held invalid.[4] For example, if a small county receives a minor development first and anticipates a larger development in the future, it could be argued that it would not be equitable or proportional for the initial developer to bear the upfront costs alone. Under a well structured system, developers would be treated fairly regardless of who got there first or of size. Developers should pay for their fair share based on the actual impact they are projected to have.

2. *Ad-Valorem Fees*: Local governments might impose a charge which they deem an "impact fee," but if the fee is based on the appraised value of the project or if it scales with the value of the project, instead of its specific impact on the existing infrastructure, then it might be a tax disguised as an impact fee.[5] Impact fees, are intended to offset the specific costs generated by a new development, while taxes are generally used to raise revenue for a variety of public purposes. This is relevant because taxes are subject to different legal requirements and constraints which might make them invalid on their face.

3. *Frontage Fees*: It can be problematic for impact fees to be determined by how much public infrastructure borders a facility, such as a street or sewer line.[6] This approach mistakenly correlates a development's impact to its mere proximity to public infrastructure irrespective of actual use or impact. For example, a larger property on a major road may not always draw more traffic than a smaller property with a smaller frontage. In a similar vein, a development next to a sewer line might not add more to the system than a development farther away. This approach fails to account for the actual impact of the development, leading to potential inequities and challenges.

4. *Flat Rates*: When impact fees are applied without consideration of whether the development is commercial, residential, or industrial, it could be considered unfair or unproportional.[7] Different types of developments require different infrastructure, and thus have different impact. For instance, a new apartment complex might increase the demand for schools and parks, while a commercial office building will likely increase traffic and the demand for parking. By applying a one-size-fits-all fee, local governments fail to account for these differences, resulting in disproportionate fees that do not align with the actual impacts.

5. *Illogical*: Fees that are computed using criteria that does not make sense in relation to the development's real effects may be deemed invalid. The impact of a development on traffic infrastructure may not be adequately reflected by a traffic signal fee, for instance, if the local government bases the fee on population size rather than the amount of additional traf-

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fic the development is projected to cause. Comparably, if water impact fees are determined solely by parcel size without taking into account the property's intended use (residential, commercial, or industrial), the fees may not reflect the true demand on the water system.

6. *Curing Existing Shortfall or Condition*: Using impact fees to address pre-existing infrastructure or service deficiencies that are unrelated to the additional demands projected to be created by the development is improper.[8] Impact fees are intended to mitigate the direct effects of new developments, not to fix existing problems in the community.

7. *Unrelated Uses*: Another factor which may raise concerns when challenging an impact fee is when the funds collected from such fees are used for purposes unrelated to what the actual impact fee relates to.[9] For instance, if money collected for road traffic improvements is used for water treatment projects, it undermines the purpose of the impact fee. Developers expect that the funds they contribute will be utilized to address the particular effects of their projects. Therefore, improper use of these funds may run afoul of legal requirements and harm the relationship between local governments and developers. The fees that are collected for specific impacts should be placed into different accounts and utilized only for the purposes for which they were intended in order to uphold accountability and transparency.

PRACTICAL STEPS FOR LOCAL GOVERNMENTS

To comply with the *Nolan/Dolan* test, local governments can take the following steps:

1. *Conduct Impact Studies*: Thorough impact studies should be conducted to assess the specific impacts of proposed developments. These studies should detail how the development will affect infrastructure and services and should be completed by experienced independent third parties.

2. *Develop Clear Fee Structures*: Fee structures should be transparent and based on the findings of impact studies. This ensures that fees are justified and proportional to the development's impact.

3. *Engage Stakeholders*: Engage with developers and community stakeholders to explain the rationale behind impact fees and bridge any gaps which can help build consensus, avoid disputes, and likely result in exploring alternatives to the development in hopes of tailoring the impact and consequentially, the impact fee.

4. *Regularly Review and Update Fees*: Periodically review and update fee structures to reflect current conditions and ensure continued compliance with legal standards.

PRACTICAL STEPS FOR DEVELOPERS

Developers can also take proactive measures to navigate the landscape of development impact fees:

1. *Seek Legal Counsel*: Engage legal coun-

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sel to review and challenge any impact fees that appear excessive or unjustified. Legal experts can help in presenting arguments based on the *Nolan/Dolan* test.

2. *Participate in Impact Studies*: Provide input during the impact study phase to ensure that the assessment accurately reflects the development's projected impact.

3. *Negotiate Fees*: Where possible, negotiate fee reductions or exemptions by presenting data that demonstrates the actual impact of the development is less than what is assumed in the fee calculation.

CONCLUSION

The *Sheetz v. County of El Dorado* decision has significant implications for the future of development. By applying the *Nolan/Dolan* test to all impact fees, the Supreme Court has provided a clearer framework for evaluating the constitutionality of these fees. Local governments must ensure their fee structures are defensible and proportionate, while developers have a clearer pathway for challenging unjustified fees. Both parties should engage in thorough analysis and open communication to navigate the complexities of development impact fees successfully.

NOTES:

[1] *Sheetz v. County of El Dorado, California*, 601 U.S. 267, 144 S. Ct. 893, 218 L. Ed. 2d 224 (2024).

[2] *Sheetz v. County of El Dorado, California*, 601 U.S. 267, 275, 144 S. Ct. 893, 218 L. Ed. 2d 224 (2024).

[3] *Sheetz v. County of El Dorado, California*, 601 U.S. 267, 284, 144 S. Ct. 893, 218 L. Ed. 2d 224 (2024).

[4] Dennis H. Ross, Impact Fees: Practical Guide For Calculation And Implementation (1992).

[5] *Bloom v. City of Fort Collins*, 784 P.2d 304, 308 (Colo. 1989); Ross, supra note 4; Development Planning & Financing Group, Inc., Impact Fee Handbook (2016).

[6] *Land/Vest Properties, Inc. v. Town of Plainfield*, 117 N.H. 817, 824, 379 A.2d 200, 205 (1977); Ross, supra note 4.

[7] Ross, supra note 4.

[8] *Upton v. Town of Hopkinton*, 157 N.H. 115, 120, 945 A.2d 670, 674 (2008); Ross, supra note 4; N.H. Rev. Stat. Ann. § 674:21.

[9] Ross, supra note 4; N.H. Rev. Stat. Ann. § 674:21.

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Recent Success in Dismissing Fraudulent Conveyance Claims in Deed-in-Lieu Transaction

By Lisa Schweitzer, Daniel C. Reynolds, Joseph Lanzkron, Thomas Q. Lynch and Timothy Wolfe[*]

In this article, the authors review recent court decisions that are helpful to lenders in highlighting circumstances where courts are amenable to dismissing frivolous challenges to deed-in-lieu agreements in bankruptcy, notwithstanding higher appraised values and allegations of lender misconduct.

On June 17, 2024, in a non-precedential summary opinion in *Wade Park Land Holdings, LLC, et al. v. Kalikow, et al.*, the U.S. Court of Appeals for the Second Circuit (the Second Circuit) affirmed a decision by the U.S. District Court for the Southern District of New York (the District Court or the Southern District), that granted a motion to dismiss fraudulent conveyance claims brought by certain property developers against several of their lenders, who had taken possession of the properties at issue via a deed-in-lieu of foreclosure agreement.[1]

The Second Circuit's order and lower court decision are notable in that they permitted dismissal of the action even in the face of allegations that the lenders had transformed "a temporary bridge loan . . . into a fraudulent scheme . . . to take control of two parcels of land," known as "Wade Park," and even though the plaintiffs cited to two appraisals for values well in excess of the outstanding loan amounts satisfied with the deed-in-lieu agreement.[2] Although the Second Circuit's summary order is non-precedential, coupled with the underlying District Court decision, these decisions are helpful to lenders in highlighting circumstances where courts are amenable to dismissing frivolous challenges to deed-in-lieu agreements in bankruptcy, notwithstanding higher appraised values and allegations of lender misconduct.

BACKGROUND

From 2012 to 2015, Georgia-based property developer Stanley Thomas acquired 176 acres of land known as Wade Park through various entities and ultimately divided the property into two parcels - a northern parcel, to which Wade Park Land LLC (WP Land) held title, and a

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southern parcel, to which Wade Park Land Holdings, LLC (WPL Holdings) held title.[3] Thomas planned to develop both properties into "office towers, retail space, residential housing units, and hotels,"[4] and financed the acquisition and initial construction on the properties with two loans in principal amount of $93 million that were set to mature in early 2017.[5] Around the same time, in November 2016, the Sage Group provided an appraisal that valued the properties, together, at $466.8 million (the Sage Appraisal).[6]

After several unsuccessful attempts to secure additional financing for Wade Park, Thomas secured a bridge loan in January 2017 from defendants Gamma Real Estate Capital, LLC (Gamma) and Jonathan Kalikow (Kalikow) for approximately $83 million.[7] The initial term of the loan was for four months, with a borrower option to extend the term three times, for three months each time, subject to satisfaction of certain conditions.

It further included a term that Kalikow referred to as "The Hammer" - which gave Kalikow, Gamma and the other defendants (WP Development Partners, Gamma Lending Omega, LLC, and GRE WP, LLC) a 75% equity interest in the Wade Park properties through an ownership interest in a bankruptcy-remote entity, and provided that they would retain that interest unless the bridge loan was repaid within sixty days of its maturity date.[8] Thomas exercised all three extension options, while he also unsuccessfully attempted to secure permanent financing for Wade Park with lenders other than Gamma and Kalikow.[9]

In January 2018, the defendants declared a default on the bridge loan, and subsequently WP Land and WPL Holdings entered into six consecutive forbearance agreements with the defendants.[10] Plaintiffs WP Land, WPL Holdings and The Thomas Family Trust alleged that during this time Kalikow and Gamma repeatedly frustrated their attempts to obtain additional financing, including buying out unrelated loans that Thomas had attempted to refinance in order to pay back the bridge loan, shouting and yelling at other lenders in meetings to discuss financing, and otherwise refusing to accept financing terms that other lenders proposed.[11] Also around that time, in January 2019, an appraisal issued by BBG, Inc. valued Wade Park at $565 million (the BBG Appraisal).[12]

In February 2019, after the expiration of the forbearance agreements, defendant Gamma Lending Omega, LLC (Gamma Lending Omega) entered into a Deed-in-Lieu Agreement (the DIL Agreement) with plaintiffs pursuant to which the plaintiffs agreed to deliver the deeds to Wade Park in exchange for approximately $140.1 million in total debt relief.[13] Gamma Lending Omega agreed to delay recording the deeds for six weeks to allow Thomas even more time to secure financing. Around the same time, the parties also entered into a buy-back agreement that provided that the plaintiffs could repurchase the properties for about $150 million within a month of signing the buy-back agreement.[14] Ultimately, Thomas was again unable to secure financing to repurchase the properties.

Plaintiffs initially filed the complaint as an adversary proceeding in the U.S. Bankruptcy Court for the Northern District of Georgia, where WP Land and WPL Holdings had filed Chapter 11 petitions, asserting eighteen causes of action against the defendants, including fraudulent transfer claims.[15] Plaintiffs

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then moved to withdraw the reference to the bankruptcy court and have the matter heard in the U.S. District Court for the Northern District of Georgia.[16] The case was then transferred to the Southern District of New York, on motion by the defendants and pursuant to a forum selection clause.[17] On March 4, 2022, the Southern District dismissed the complaint with prejudice, but granted the plaintiffs leave to amend their complaint to replead their fraudulent transfer claims.[18]

THE DISTRICT COURT'S DECISION

After the plaintiffs repled their fraudulent conveyance claims, the District Court again granted defendants' motion to dismiss, holding that it was "utterly implausible that the transfer was for anything other than reasonably equivalent value."[19] The District Court ran through a number of facts that, when taken together, underscored that the transfer pursuant to the DIL Agreement was for reasonably equivalent value.

In reaching its decision, the District Court focused on the extensive history of Thomas's attempts to obtain financing to repay the bridge loan, as well as the affidavits signed by plaintiffs in connection with the DIL Agreement, which stated that they believed that the "consideration [for the deeds] represents the fair market value of the property," even though the plaintiffs were aware of the appraisal values.[20] The District Court also pointed to the plaintiffs' right to sell, refinance or buy back the properties for a period of time after signing the DIL Agreement, and the defendants' offer of a buy-back agreement at $150 million, none of which rights were exercised by the plaintiffs, in concluding that the "only inference to be drawn is that in 2019, as in the over one year period prior, there was no buyer or lender who would value the property at $565 million, or anywhere close."[21]

In the face of these facts, the District Court dispensed with the BBG Appraisal of $565 million. Given that plaintiffs failed to introduce the full appraisal, and that the cover letter the plaintiffs did introduce included only conclusory opinions about the value of Wade Park, the District Court held that the appraisal was insufficient to "create a plausible inference that the DIL Agreement was for other than reasonably equivalent value," even at the motion to dismiss stage.[22] The District Court also noted that appraisals are generally "worth only as much as their models and assumptions are worth."[23] Here, the appraisal cover letter did not include any detail of the credentials of the appraiser, the methodology used, or any underlying assumptions.[24]

The District Court likewise dispensed with the plaintiffs' attempt to rely on the Sage Appraisal of $466.8 million, noting it predated the deed-in-lieu transfer by more than two years.[25] As such, the Sage Appraisal was insufficient to support a plausible inference that the DIL Agreement was for other than reasonably equivalent value.[26]

Finally, the District Court addressed the allegations of interference by the defendants with the plaintiffs' attempts to obtain financing.

First, the District Court concluded that no interference was alleged during the months surrounding the DIL Agreement or buy-back agreement.[27]

Second, the District Court found that there was "no reasonable basis to infer anything other than that Defendants were simply insist-

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ing on being paid for the debt that was owed to them."[28]

As such, the District Court concluded that the allegations were "insufficient to establish that Defendants acted with the intention of preventing Plaintiffs from obtaining financing."[29]

THE SECOND CIRCUIT'S DECISION

In its summary order, the Second Circuit affirmed the District Court's decision, largely adopting the same reasoning. The Second Circuit's review focused on whether the District Court gave proper weight to the two appraisals, whether the District Court accurately accounted for Thomas's ability to obtain financing or sell the property, and the representations made in connection with the DIL Agreement.[30]

Regarding the appraisals, the Second Circuit affirmed the District Court's holding that the "values stated in the Sage and BBG Appraisals were not plausible when viewed in light of other allegations in the complaint - in particular, the conduct of the parties and Thomas's inability to refinance Wade Park."[31] Like the District Court, the Second Circuit noted that appraisals are only as valuable as the methodology and assumptions used, and here, the Second Circuit found that those were "questionable," calling out the heavy reliance on Thomas himself for estimates used in the appraisals.[32]

The Second Circuit also similarly focused on the history of Thomas's failures to obtain financing and stated that Thomas's inability to refinance the properties reinforced the conclusion that they were worth no more than $150 million.[33] The Second Circuit was also unmoved by the plaintiffs' allegations that the defendants interfered with their financing efforts, noting it was entirely in Gamma's interest to allow refinancing so that they could be paid what they were owed.[34]

Further, the Second Circuit stated that Gamma's conduct was inconsistent with it believing that Wade Park was worth more than the value reflected in the DIL Agreement and that Gamma's offer to allow Thomas to buy the property back at $150 million "would have been irrational if Gamma believed that the property was worth much more."[35]

Finally, the Second Circuit held that the transfer pursuant to the DIL Agreement was for reasonably equivalent value for an additional reason - Gamma provided reasonably equivalent value "in the form of the opportunity to retain ownership of Wade Park."[36]

KEY TAKEAWAYS

Although non-precedential in nature, the Second Circuit's summary order is notable given that it dismissed fraudulent conveyance claims on a motion to dismiss. While in other contexts fraudulent conveyance claims may be difficult to dismiss at this early stage, the Second Circuit's order and the District Court's underlying decision indicate that courts are amenable to dismissing frivolous challenges to deeds-in-lieu in certain circumstances. These circumstances include where questions exist on whether reasonably equivalent value was received, notwithstanding higher appraisal values and allegations of lender misconduct, and when it can be established that the borrower agreed to a deed-in-lieu instead of effectuating an alternative transaction, such as a sale, consent to foreclosure, or refinancing that could have preserved additional value had it existed.

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NOTES:

[1] *In re Wade Park Land Holdings, LLC*, 2024 WL 3024648 (2d Cir. 2024) (summary order) [hereinafter the Second Circuit Order].

[2] *Wade Park Land Holdings, LLC v. Kalikow*, 2023 WL 2614243 (S.D. N.Y. 2023), aff'd, 2024 WL 3024648 (2d Cir. 2024) at 2 [hereinafter the District Court Opinion].

[3] District Court Opinion at 2.

[4] District Court Opinion at 2.

[5] District Court Opinion at 2.

[6] District Court Opinion at 9.

[7] District Court Opinion at 3.

[8] District Court Opinion at 3–4.

[9] District Court Opinion at 4.

[10] District Court Opinion at 5.

[11] District Court Opinion at 6.

[12] District Court Opinion at 8–9.

[13] District Court Opinion at 7.

[14] District Court Opinion at 8.

[15] Second Circuit Order at 7.

[16] Second Circuit Order at 7.

[17] District Court Opinion at 11.

[18] District Court Opinion at 13.

[19] District Court Opinion at 28, 30.

[20] District Court Opinion at 30, 33.

[21] District Court Opinion at 32.

[22] District Court Opinion at 34.

[23] District Court Opinion at 37.

[24] District Court Opinion at 38. The District Court separately addressed whether plaintiffs should be allowed to replead with the full appraisal report attached to the amended complaint. However, the District Court noted that the statements of value in the report were conclusory and supported by assumptions and explanation that were "either absent or informed by the developer itself." District Court Opinion at 42.

[25] District Court Opinion at 38–39.

[26] District Court Opinion at 39.

[27] District Court Opinion at 40.

[28] District Court Opinion at 41.

[29] District Court Opinion at 39.

[30] Second Circuit Order at 9.

[31] Second Circuit Order at 10.

[32] Second Circuit Order at 13–14.

[33] Second Circuit Order at 12.

[34] Second Circuit Order at 12.

[35] Second Circuit Order at 12–13.

[36] Second Circuit Order at 15.

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You Are a Landlord and Your Tenant Is Financially Stressed - What Should You Do?

By Abbey Hone, Patrick L. Hughes, Abby Johanson, Rebecca Landau and Jeremy Herskowitz[*]

Tenant bankruptcy cases significantly impact landlords. In this article, the authors explore some of the issues that arise when a tenant is financially stressed and the potential mitigating actions from the perspective of the landlord.

In the current economic environment, many commercial tenants are experiencing severe financial distress. This leads to an increasing risk of tenants filing bankruptcy, which will impact landlords on several levels. Even before a tenant files bankruptcy, the tenant's financial distress itself gives rise to various legal considerations that can affect the landlord's loss exposure.

Prior to the bankruptcy filing, a number of matters - including tenant delinquencies, rent deferrals and abatements, lease transfers and assignments, the status of lease guarantees and security deposits, and the status of insurance maintained by the tenant with respect to its premises, as well as the tenant's overall level of distress - require careful consideration by a landlord in order to help avoid or mitigate the landlord's risks of (i) exposure to loss, and (ii) encountering complications in its attempts to quickly assert control over the tenant's leasehold interest.

After the bankruptcy filing, the landlord must proceed with caution in connection with enforcing its rights. The Bankruptcy Code (the Code) imposes an immediate "automatic stay" in favor of any debtor, which is essentially an injunction intended to protect a debtor and its property against any action that may be taken by a creditor without obtaining prior bankruptcy court authorization. The automatic stay applies both in situations where the debtor itself (e.g., a tenant) files a "voluntary" bankruptcy or another party files an "involuntary" bankruptcy against the debtor. In order to proceed against a debtor that is subject to a stay, relief from the stay - which may only be granted by the bankruptcy court itself - must be obtained prior to the taking of any action by a creditor. Violations of the stay are subject to a contempt action before the bankruptcy court.

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Leases are considered "executory contracts" for purposes of the Code since material performance is due by the parties on both sides of the agreement. The Code contains special provisions relating to the treatment of leases in bankruptcy. While as a general matter debtors must perform their lease obligations that arise after bankruptcy, debtors may have flexibility to take advantage of somewhat more relaxed compliance oversight during the early stages of a bankruptcy case (barring rapid creditor landlord intervention). Note that it is not recommended for a landlord to unilaterally take self-help measures once a bankruptcy is filed.

There are instances where leases that are of value to a debtor are ultimately "assumed" in a bankruptcy.[1] In such an event, all existing defaults under such lease will need to be cured and all outstanding rent must be paid in full to the landlord. However, it is more often the case that the relevant lease is of little or no value to a debtor, in which event the debtor may seek to "reject" the lease.

Frequently, the debtor's ability to reject a lease in a bankruptcy leaves the affected landlord in an unpredictable and risky situation. There are certain proactive steps that landlords should consider taking in situations where a tenant may be headed for, or imminently preparing to file, bankruptcy. While every situation is unique (and the particular level of distress that the applicable tenant is experiencing will certainly impact the nature of the actions that can be taken to mitigate losses and enhance recoveries), there are certain recurring issues that often arise in these situations that a proactive landlord can anticipate and thereby attempt to minimize the resulting adverse financial consequences. This article will explore some of these issues and potential mitigating actions from the perspective of the landlord.

STAYING INFORMED ABOUT TENANT DISTRESS

In many situations, the landlord may not fully appreciate the extent of a tenant's financial distress. Late or missed rent payments are often the first indicator that a tenant is experiencing difficulty. However, this might not occur until the tenant is already in bankruptcy, at which point the landlord must immediately begin to monitor the bankruptcy case because matters can occur quickly and may, absent vigilance, impact the landlord's ultimate recovery.

While some leases contain financial reporting requirements that may provide insight into a tenant's financial status, these provisions often require only annual reporting, so they can become quickly outdated (and tenants may also not report the full extent of their precarious financial situation). Other lease provisions may give the landlord the right to request (or require the delivery of) current financial information from the tenant. As an initial matter, landlords should strive at all times to stay informed regarding the current financial status of their tenants,[2] since receiving an early warning on distress may enable the landlord to pursue certain remedies prior to the occurrence of a bankruptcy (which remedies would otherwise likely be subject to the automatic stay after the bankruptcy).

TERMINATION OF THE LEASE MAY BE HELPFUL

If a tenant is not already in bankruptcy, then, upon learning that a tenant is experiencing

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financial distress, an initial course of action for the landlord to consider is whether it has the ability to terminate the lease by its terms (in a manner that makes such termination irrevocable) before the bankruptcy case is filed. This requires careful consideration not only of the business impact of such termination, but also of the specific terms of the lease and underlying state law. Otherwise, once the bankruptcy case commences, (i) the lease (if it is still in the phase where existing pre-bankruptcy tenant defaults can potentially be cured) remains in place without any right for the landlord to terminate (absent specific bankruptcy court approval), and (ii) the landlord and all other creditors are, at least temporarily, stayed from taking any actions to enforce rights or remedies that would have been available pre-bankruptcy.

In evaluating the decision whether to terminate a lease pre-bankruptcy, the actual lease terms are controlling as to (among other things) the nature of the circumstances that would allow the landlord to terminate and how to effectuate such a termination.[3]

In addition, many leases contain notice and cure rights in the event of certain tenant defaults and/or a provision stating that a termination notice only becomes effective after a certain number of days pass following the delivery of the notice to the tenant. If the tenant files bankruptcy either during the pendency of a tenant cure period or during the period between the delivery of the termination notice and the date it becomes effective pursuant to the terms of the lease, then the termination will not be considered effective and the lease will still be considered in effect. From the perspective of avoiding entanglement in bankruptcy, if a lease termination is not clearly, fully and finally effective before a bankruptcy case is filed, then any further landlord acts to implement termination would be deemed to be a violation of the automatic stay.

In short, the timing of the delivery of a termination notice and the provisions of the lease governing its effectiveness should be taken into account when considering this option.

ACCELERATION OF RENT CONSIDERATIONS

Any attempts by a landlord to accelerate rent under a lease following a bankruptcy filing are also barred by the automatic stay. As such, any acceleration of rent under a lease must be implemented and become effective before the bankruptcy is filed.

Additionally, (i) in some jurisdictions, the termination of a lease can operate to cut off all future obligations of the tenant thereunder, so local counsel should also be consulted to understand the mechanics of lease termination in the applicable jurisdiction, and (ii) local counsel should also be consulted with respect to the applicable jurisdiction's mitigation of damages requirements (including to understand the landlord's obligations under such circumstances and to frame any potential future damages claim or proofs of claim that may ultimately be pursued in bankruptcy court).

NEGOTIATION WITH THE TENANT

If the landlord does not pursue lease termination, then it may want to consider engaging the tenant in discussions regarding how the lease will be treated in the bankruptcy. With respect to more marginal leases, the tenant

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will likely be desirous of reducing damages claims under the lease and, therefore, a consensual, early exit from the lease might be beneficial to both parties. Assuming that both parties are in agreement, one potential approach could be to enter into a surrender agreement, whereby:

(i) The tenant agrees to vacate the premises;

(ii) The parties agree to liquidate the remaining amounts owed by the tenant under the lease to a fixed sum, and

(iii) The landlord retains and applies the entire security deposit. As consideration for such a lease surrender, the landlord will often agree to waive some or all claims against the tenant.[4]

Again, the bankruptcy court and other creditors will typically review this type of arrangement carefully, whether the same is implemented before or after the bankruptcy filing. If any surrender agreement or similar arrangement is effectuated (i) after the bankruptcy filing, then it will need express bankruptcy court approval, and (ii) before the bankruptcy filing, then after the filing the bankruptcy court can still evaluate whether the overall agreement resulted in a "transfer" of value away from the debtor tenant to the landlord in a manner that could be subject to "avoidance" by the court under various sections in the Code. Generally, any agreement that purports to transfer new value to the landlord with respect to the period prior to bankruptcy (i.e. value that goes beyond the amount of any existing deposits held by the landlord) could trigger increased scrutiny from other creditors and should be thoroughly evaluated by the landlord.

ACTING ON SECURITY DEPOSITS OR OTHER PAYMENT ASSURANCES

As a general matter, when entering into a lease, a landlord will often seek to (i) achieve "secured" status as to any cash security (or other advance) deposits that it holds under the lease, or (ii) otherwise obtain reasonable assurances or collateral for a tenant's obligation to make all required payments under its lease (such as letters of credit or third-party guarantees).

If a landlord learns of a potential upcoming bankruptcy filing with respect to a tenant, then, to the extent permitted by the terms of the applicable lease, the landlord should consider applying any cash security deposits it is holding to amounts due under the lease (including acting to trigger any acceleration of rent pursuant to the terms of the lease and in accordance with applicable law).

If the application of a cash security deposit or acceleration of rent does not fully and irrevocably occur before the bankruptcy filing, then the bankruptcy filing itself will automatically stay landlord's ability to apply the cash security deposit or accelerate the rent (absent the express approval of the bankruptcy court). With respect to a security deposit that is in the form of a letter of credit or a third-party guaranty, because each such instrument is a third-party obligation that is independent of the debtor tenant, the filing of a bankruptcy by (or with respect to) the tenant should not, in and of itself, ordinarily interdict the landlord's ability to draw on the letter of credit or seek to collect under the guaranty (unless the issuer of the letter of credit or the guarantor is also subject to a bankruptcy filing).

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CONFIRM INSURANCE STATUS ASAP

Another important initial item from the landlord's perspective is to make sure that the tenant does not allow the applicable property, casualty and other insurance to lapse (which could lead to the existence of a gap in coverage if a casualty or other covered event occurs). As part of the termination process, a landlord should also review the status of the existing insurance and confirm that (if the tenant is responsible for obtaining and maintaining such insurance) (i) the landlord is appropriately named on the applicable policies as a loss payee or co-insured, and (ii) such insurance coverage will not lapse due to a bankruptcy filing.[5] The bankruptcy courts and the U.S. trustee monitoring the bankruptcy will react swiftly to complaints made by creditors (or other affected parties) if there are lapses by a debtor tenant in maintaining proper insurance. As is the case with virtually all proactive action by a landlord, if a tenant allows its insurance to lapse in breach of a lease and then becomes subject to a bankruptcy, then the landlord will need to act within the bankruptcy process in order to remedy this matter (and other similar types of matters).[6]

SECURING THE PREMISES

A distressed tenant may leave the demised premises unoccupied or in an abandoned state. In such a scenario, whether prior to or during a bankruptcy, the landlord should consider arranging for security to ensure that the premises is secure. However, this does not mean taking over the debtor tenant's leasehold or acting to control its property, unless (i) before the bankruptcy, the same is permitted by the applicable lease, or (ii) during the bankruptcy, the same is specifically authorized by the bankruptcy court.

WILL THE LEASE BE ASSUMED, REJECTED OR ASSUMED AND ASSIGNED IN THE BANKRUPTCY?

As noted earlier, leases are considered "executory contracts." The Code gives debtor tenants the opportunity to either assume, reject or assume and assign leases,[7] even if the lease provisions say otherwise. While there are some limited exceptions to a tenant's right to assign its lease in bankruptcy (e.g., in the case of shopping center leases), landlords are often hindered in their ability to oppose assignments by tenants since a debtor's decision to assume, reject or assign a contract in bankruptcy is subject to a business judgment standard. In any event, the landlord should try to assess how the leased premises fits into the debtor's business and otherwise contributes to the debtor's overall profitability. These decisions are present in virtually all tenant bankruptcy cases.[8] As a practical matter, unless a lease is a cornerstone asset that is essential to the business of the debtor tenant, the landlord may need to provide the tenant with incentives (including economic concessions) in order for the tenant to agree to assume the lease and cure defaults.

Note that the Code imposes certain time limits on when the debtor tenant must decide to assume, reject or assume and assign its lease (which can vary depending on the nature of the lease or asset-type). And while the terms of a lease may provide for "automatic termination" or other consequences in the event of a bankruptcy, these "ipso facto" provisions are nullified and rendered void under the Code.

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RENEGOTIATING THE LEASE TERMS

As previewed above, the Code's provisions regarding assumption, rejection or assignment of leases (as well as the cap on available damages for rejection of a lease) provide substantial incentives for fostering renegotiation of the terms of a lease with a debtor tenant since the tenant can seek to reject the lease if, in its business judgment, the existing lease terms are too burdensome or unprofitable to assume from the tenant's perspective. Renegotiation may be an especially attractive option in situations where the space demised under the lease cannot be re-leased easily or quickly (in which case renegotiating the lease terms may be the most effective way to avoid vacancy at the property and further loss of rental income).[9] Lease amendments or modifications can be effectuated both before and after the bankruptcy is filed, but once the filing occurs the applicable lease transaction would require the prior approval of the bankruptcy court. Additionally, pre-bankruptcy agreements must be carefully crafted to avoid undermining any protections or rights that the landlord already possesses pursuant to the existing terms of the lease. Although it is not common for these types of pre-bankruptcy transactions to trigger the Code's avoidance provisions on account of a transfer of value from a debtor tenant to the landlord, they are still subject to review after the fact in the bankruptcy to ensure that the value exchanged is not "unreasonable" or too one-sided in favor of the landlord.

MY ONLY CONCERN IS MY LEASE - NOT THE REST OF THE CASE

Bankruptcy cases are generally filed to implement a holistic restructuring of the debtor's asset mix and debt structure, with the intention of erasing debts in order to right-size the debtor's balance sheet and discard unprofitable assets. The cases are multi-faceted and can have wide-ranging effects (especially if an affected landlord is not vigilant in monitoring the ongoing developments in the case). Bankruptcy can also be used to attempt to relieve owners or other involved parties from loss exposure. It is important for a creditor landlord to engage legal counsel to monitor the bankruptcy case in order to (i) ensure that the case does not override the landlord's existing rights in the leasehold and associated third party guarantees, and (ii) evaluate whether there are other potential sources of value recovery for creditors that should be preserved. This often involves a cost-benefit analysis by the landlord as to whether active involvement in the case is warranted. The courts are increasingly placing the burden of imposed harm to rights on affected creditors who do not actively protect their rights in the bankruptcy (particularly in situations where creditors were given the opportunity to object to the granting of debtor relief that adversely affects the creditors' interests).

MY LEASE WAS REJECTED - IS THERE ANYTHING ELSE TO DO?

Landlords whose leases are rejected are often left with a significant unsecured rejection claim in the bankruptcy. The actual amount of the claim is calculated based on the terms of the lease; however, the amount of damages collectible by a landlord as a result of the termination of a lease is statutorily capped at the greater of rents due for (i) one year, and (ii) 15% of the remaining lease term (not to exceed three years). In addition, landlords may also be able to pursue other residual claim recoveries in the bankruptcy case, including

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(potentially) the full balance of the lease claims against non-debtors under guarantees or letters of credit.

CONCLUSION

The existence of a distressed tenant is always unwelcome news for the landlord. However, there are steps that may be taken by the landlord to attempt to minimize the resultant financial loss and disruption. Every situation related to a filing (or potential filing) of bankruptcy is different and fact-specific, so any landlord that is faced with the prospect of a tenant bankruptcy should always consult with an attorney that is knowledgeable about both the relevant lease and the potential impact of the bankruptcy on the landlord's rights.

NOTES:

[1]The "assumption" of a lease in bankruptcy essentially means that the parties elect to keep the lease in effect and continue to perform thereunder. On the other hand, the "rejection" of a lease in bankruptcy essentially means that the parties elect to void the lease and thereby relegate all claims by landlord for damages under such lease to the status of unsecured claims.

[2]To that end, landlords should consider whether they have the right under the applicable lease to require the tenant to deliver current financial reporting information upon demand.

[3]Note that termination rights may be subject to numerous factors, including (i) matters that are solely bilateral between landlord and tenant (e.g., failure to pay rent or other required amounts, or other nonmonetary defaults), and (ii) external matters (e.g., obtaining the approval of a lender, governmental authority or other third party where applicable).

[4]As part of this process, the landlord should consider, among other things, its expectations of recovery of amounts owed under the lease from other third parties, as well as what any residual unsecured claim might be worth in a bankruptcy case. Typically, unsecured creditors do not see a significant return in bankruptcy cases, although each situation is different.

[5]This is applicable and important even if the tenant has pledged its insurance coverage to the tenant's lender.

[6]Note that this is the case even if the landlord is the named insured or an additional insured on such policies, because insurance policies procured by the debtor comprise property of the bankruptcy estate.

[7]If a lease is (1) "assumed" by the debtor, then the lease remains ongoing for the duration of the bankruptcy; (2) "rejected" by the debtor, then the lease will be terminated; and (3) "assumed and assigned" by the debtor, then the lease will continue with the assignee serving as the new tenant thereunder.

[8]Note that while a bankruptcy filing will essentially excuse the debtor's performance of certain pre-filing obligations, it does not affect the debtor's obligations to perform and pay amounts due under the lease for the post-bankruptcy period. Generally speaking, debtor tenants are required to pay rent for the post-bankruptcy period (subject to certain qualifications and provisions of the Code).

[9]For example, this was one of the main areas of focus in the WeWork restructuring.

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California's Hotel and Private Residence Rental Reservation Refunds Law Is Now in Effect

By Stacie Andra Goeddel and Samara Harris[*]

In this article, the authors discuss a new California law that requires hotels, third-party booking services, hosting platforms and short-term rental locations to allow a cancellation without penalty for at least 24 hours after the reservation is confirmed if the cancellation is made at least 72 hours before check-in time.

A new California law that enables people making hotel accommodations or short-term rentals to cancel their reservations without penalty under certain parameters has become effective. California Senate Bill 644, the Hotel and Private Residence Rental Reservation Refunds Law, was signed by Governor Gavin Newsom on October 10, 2023. It requires hotels, third-party booking services, hosting platforms and short-term rental locations (collectively, the Hotel Service) to allow a cancellation without penalty for at least 24 hours after the reservation is confirmed if the cancellation is made at least 72 hours before check-in time.

Upon such cancellation, the Hotel Service must issue a refund for all amounts paid to the Hotel Service to the original form of payment within 30 days. Such refund shall include all fees charged to the consumer for optional services. Each violation of the law could result in a civil penalty of up to $10,000, with each day that a defendant does not honor the refund constituting a single violation. There is no private right of action under this law, and an enforcement action may be brought only by the state attorney general or a district attorney (or its city prosecutor), city attorney for a city with a population in excess of 750,000 or county counsel for a county with a population in excess of 750,000.

The law does not apply to reservations that meet any of the following criteria:

- The reservation was completed for a negotiated rate that was not made available for booking by the public.
- The reservation is for a hotel or short-term rental reservation confirmed before July 1, 2024.
- The reservation is one in which the specific hotel or short-term rental is not

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disclosed to the consumer until after the booking is confirmed.

THE SPECIFICS

Among other particulars:

- The law applies to hotel accommodations and short-term rentals, but not to residential hotels.
- The law does not apply to reservations that begin on or after July 1, 2024, but were booked on or before June 30, 2024.
- If a consumer books with a third-party booking service or hosting platform, such third-party booking service or hosting platform will be responsible for refunding the consumer.

Relevant terms in the law:

- "Hotel" means a hotel, motel, bed and breakfast inn, or other similar transient lodging establishment in California but does not include a residential hotel, as defined in Cal. Health & Safety Code § 50519.
- "Residential hotel" means any building containing six or more guestrooms to be used, rented or hired out for sleeping purposes by guests and also is the primary residence of those guests. This does not include any such building that is used primarily by transient guests who do not occupy that building as their primary residence.
- "Short-term rental" means a residential dwelling, or any portion of a residential dwelling, in California that is rented for 30 or fewer consecutive days.

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Exploring Global Real Estate Gems Amid Soaring U.S. Prices

*By Ronan McMahon**

In this article, the author discusses the benefits of various international real estate locations for investors.

Quality of life has become a luxury for many in the U.S., and the situation is only worsening. According to recent data from the National Association of Realtors (NAR),[1] the median existing-home price in the United States for all housing types hit $393,500 in March 2024, a 4.8% increase on last year's numbers - which is to say nothing of desirable real estate.

Factor in global conflicts, supply-chain disruptions, and high inflation rates reducing the purchasing power of the average citizen, and the picture looks even bleaker.

What if your dreams of a high-quality, affordable life were not out of reach, and all you needed to do was look elsewhere? Despite rising prices worldwide, there are still corners of the globe where you can find incredible dream homes at affordable prices. Whether it is a charming villa in France or a seaside escape in Costa Rica, the possibilities are within your grasp. Here are the first five places to start your search.

BARGAINS IN NORTHERN PORTUGAL

Over the past several years, Portugal has seen a dramatic influx of tourists and expats. As a result, good-value real estate opportunities in the popular, southern locales of Lisbon and the Algarve have become more difficult to find, while the hitherto unappreciated north has entered global awareness. In the Greater Porto area, a once-overlooked city, house prices are already up 61% since 2019, according to data from the National Statistics Institute (INE).[2]

Just across from Porto, on the south bank of Douro River, lies its relatively inexpensive sister city, Vila Nova de Gaia. Gaia's 16 miles of Atlantic beaches and expansive boardwalks with restaurants and cafés remain largely unknown to foreign tourists, as do its marinas and other facilities directly on the Douro River. Yet all of this is a mere 13-minute drive from downtown Porto, placing the city's historic neighborhood on the doorstep of a Gaia resident. And real estate prices in Gaia can be a fraction of what you will find just across the water in Porto. Prices can start at around €200,000 ($213,846) for an appealing two-bedroom apartment in the Gaia area.

*Ronan McMahon is a global real estate scout.

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LUXURY FOR LESS IN FRANCE

The bucolic farmhouses and Mediterranean Sea-views of southern France are often neglected under the assumption that such desirable real estate will be unaffordable - and with good reason. The ever-popular region of Provence feature some of the priciest homes in France. However, look just a short way southwest, and remarkable opportunities begin to appear.

Once known as the "Poor Man's Provence," the Languedoc region sports the same sandy beaches, mountain ranges, dramatic gorges, and picturesque hilltop villages offered by its neighbor, but with far fewer tourists and as little as a third of the cost. For example, in the Languedoc region, investors can find a historic one-bedroom village house for as little as €60,000 ($64,135). A budget of around €200,000 ($213,784) could get you a luxury three-bedroom house in a charming village or a historic six-bedroom mansion to renovate.

THE GOOD LIFE IN ITALY

Italy is one of the most evocative places in the world . . . the wine, the history, the food, the architecture. It is also among the visited destinations on the planet. Yet for decades, Italy's economy has lagged behind other major countries in Western Europe, while it is rural towns and cities have suffered from massive depopulation as its young people emigrate in search of opportunities. As a result, while expensive properties are bountiful in areas of Italy that attract global elites, those who look off the beaten path are likely to uncover incredible bargains.

Tuscany, for instance, offers some very noteworthy real estate. The region is world-famous for its beauty, history, and cuisine, which has increased prices in some of its most famous cities and towns. Nonetheless, corners of Tuscany remain where one can enjoy all it offers without paying a fortune. One such example is the town of Bagni di Lucca, in the forest-clad foothills of the Apuan Alps. Here, you can spend as little as €60,000 ($64,135) to get a fully renovated apartment or spacious townhouse. If you prefer to spend a little more, €250,000 ($267,230) will buy you a large house in the hills with panoramic views.

TRANQUIL, SAFE, WELCOMING COSTA RICA

Costa Rica is safe, stable, welcoming, and gorgeous. Its unspoiled beaches, crashing waterfalls, smoking volcanos, and sprawling rainforests make it a veritable paradise for sporty outdoorspeople and relaxed vacationers alike. As such, Costa Rica has received much international attention.

The Guanacaste region, in particular, is worth monitoring for prospective expatriates. Its beaches, forests, and near-perfect climate make for desirable real estate. Towns like Playa Flamingo, Playas del Coco, and Tamarindo feature walkable seaside villages and expat enclaves with plenty of amenities. While the popularity of Guanacaste has made it more expensive than other parts of the country, investors can still purchase homes near the beach at a reasonable price. For the best real estate prices, look for properties just outside town. For example, a 10-minute drive from Tamarindo, you could find a fully furnished two-bedroom home with a terrace and jacuzzi for €373,235 ($399,999).

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GORGEOUS GREENERY IN IRELAND

On a sunny day, Ireland is among the most beautiful places in the world. A shimmering ocean, powdery beaches, and rolling green hills make for many picturesque views and just as many desirable homes for prospective buyers. However, real estate prices in Ireland are currently high and unlikely to abate while demand outpaces supply. If investment and returns are the priority, you should look elsewhere.

But Ireland may offer some considerable deals for those merely seeking a beautiful place with culture, history, and music to which they can escape. The further away you look from the country's major cities, the more value you will likely find. For instance, counties in the west of Ireland offer more affordability than the regions around Dublin and Cork without sacrificing the natural beauty, history, and culture that make Ireland unique.

You might want to consider County Mayo, in the west of Ireland, a scenic region known for its rugged coastline, picturesque landscapes, and rich cultural heritage. Expect to pay around €200,000 ($217,000) and above for a nice rural cottage with some land.

CONCLUSION

From riverside cities in Portugal to rolling landscapes in Ireland, the potential for an idyllic life in a stunning home awaits those willing to search beyond the United States. The five places listed here provide a starting point for Americans looking to escape the rising cost of living and prohibitively expensive real estate market in favor of a higher-quality, more affordable way of life.

NOTES:

[1] https://www.nar.realtor/blogs/economists-outlook/latest-existing-home-sales-data-graphs#:˜:text=The%20national%20median%20existing%2Dhome,with%20an%20incline%20of%209.1%25.

[2] Id.

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New York Could Further Limit Retainage on Public and Private Construction Projects

*By Adam J. Paterno, Timothy B. Froessel and David McNamara**

In this article, the authors discuss recent actions taken by New York legislators to further limit retainage in construction contracts.

Proposed bills in the New York State Assembly and Senate would prohibit the retention of any amount of payment due and owing for materials delivered and accepted for public and private construction projects. The identical bills, Senate Bill 6855[1] and Assembly Bill 1194,[2] are designed to amend Section 139-f of the State Finance Law (Payment on public works projects),[3] Section 106-b of the General Municipal Law (Payment on public works projects)[4] and Section 756-c of the General Business Law (Retention).[5] Both Section 139-f of the State Finance Law and Section 106-b of the General Municipal Law concern payment on public work projects, and the proposed amendments would require full payment for delivered and accepted materials that are covered by a manufacturer's warranty and/or graded to meet industry standards pertinent to any public works projects.

The payment-in-full obligation applies to payments due from public owners to contractors and flows down to payments from contractors to subcontractors. Materials falling within the proposed legislation include materials delivered to a project site and materials delivered off-site that have been suitably stored and secured as required by the owner/contractor. Section 756-c of the General Business Law concerns retention on all construction projects (i.e., it applies to private construction projects) and, if the proposed legislation is passed, retainage would be prohibited for any payment due and owing to a material supplier for materials that have been delivered and accepted and are covered by a manufacturer's warranty and/or graded to meet industry standards.

PROPOSED LEGISLATION

In sum, the proposed legislation removes materialmen from inclusion under current retainage laws. If passed, these amendments require full payment for delivered materials pertaining to public works projects and prohibit the retention of any payment due and owing to a material supplier on any type of construction project.

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The justification behind this proposed change in the law is that once a material supplier has delivered its goods and such goods have been accepted by the owner or contractor, the supplier has completed its portion of the work and should not have retention withheld if the owner or contractor has alternate remedies available to it.

Project owners should be advised, however, that issues with materials often do not come to fruition until after they have been installed and/or are in use. From the owner's perspective, the advantage of retainage is that it affords them funds to immediately address defective materials on account of issues that arise after delivery has taken place and helps owners ensure that they are satisfied with the finished product.

If the proposed amendments are passed, owners, rather than relying on retainage, would instead have to deal with manufacturers directly to address nonconforming or defective materials, which may be more difficult since owners typically are not in privity of contract with the manufacturers. Owners may need to consider implementing more rigorous inspection protocols when critical materials are delivered to ensure that they conform with the contract and have no visual signs of damage before they are deemed accepted.

If passed, this legislation would make provisions relating to the assignment of supplier warranties even more important when construction contracts are drafted.

CONTINUING TREND

This proposed legislation follows a general trend of the state intervening in private construction contracts insofar as payment terms are concerned - one that began in 2003 with the passing of the Prompt Payment Act (legislation designed to expedite payments and facilitate disputes between owners and contractors and between contractors and subcontractors on certain private construction projects) - and continued last year with passage of Senate Bill S339,[6] which amended the Prompt Payment Act by restricting the amount of retainage that can be withheld on construction contracts of at least $150,000 to no more than 5 percent.

IN SUMMARY

- Assembly Bill 1194 and Senate Bill 6855 are the most recent actions taken by New York state to further limit retainage in construction contracts.
- The proposed legislation would amend the New York State Finance Law, General Municipal Law and General Business Law to prohibit the retention of any payment due and owing a material supplier on construction projects.
- These amendments follow a New York state trend of limiting retainage that began in 2023 with the passage of Senate Bill S339, which restricted the amount of retainage to no more than 5 percent on private construction contracts of at least $150,000.

NOTES:

[1] https://www.nysenate.gov/legislation/bills/2023/S6855/amendment/A.

[2] https://www.nysenate.gov/legislation/bills/2023/A1194/amendment/A.

[3] https://www.nysenate.gov/legislation/laws/STF/139-F.

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[4] https://www.nysenate.gov/legislation/laws/GMU/106-B.

[5] https://www.nysenate.gov/legislation/laws/GBS/756-C.

[6] https://www.nysenate.gov/legislation/bills/2023/S3539.

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Calling All Cash Money Millionaires: FinCEN Proposes New Reporting Rules for Cash Residential Real Estate Transfers

*By Warren Seay, Jr. and Rachel E. Collins**

In this article, the authors review proposed rules from the Financial Crimes Enforcement Network intended at increasing transparency in the domestic residential real estate market.

The Financial Crimes Enforcement Network (FinCEN), a division of the U.S. Department of the Treasury, has proposed new rules aimed at increasing transparency in the domestic residential real estate market.[1] These rules would require professionals involved in certain real estate transactions to disclose information about non-financed (cash) transfers of residential real estate to legal entities or trusts. This comes as part of a large-scale effort by the Treasury to increase transparency in the U.S. residential real estate market.

FinCEN's focus is on "all-cash" residential real estate transactions, which have been identified as a common method for money laundering. While financed transactions are subject to anti-money laundering (AML) standards and must file Suspicious Activity Reports (SAR) under the Bank Secrecy Act, non-financed transactions have not been subject to these requirements. The Treasury estimates that 20–30% of residential real estate purchases in the United States are made without financing, and thus, are not subject to AML checks.[2]

Previously, FinCEN introduced geographic targeting orders (GTOs) in Miami and New York City to mitigate all-cash residential real estate transactions. These GTOs required professionals involved in real estate closings and settlements to report the beneficial owners to the agency.

A NEW FORM

The proposed rules would replace the existing GTOs with a nationwide reporting requirement. FinCEN proposes a new form, the Real Estate Report, to streamline the SAR reporting requirements. The Real Estate Report would need to:

1. Identify the business filing the report (the reporting person);

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2. Provide information about the real property being sold or transferred;
3. Provide information about the transferor (e.g., the seller);
4. List beneficial ownership information for the legal entity or trust acquiring the property; and
5. Provide information about any payments made.

The proposed rule would require reporting within 30 days after transfers of various types of residential real estate, including single-family houses, townhouses, condominiums, and cooperatives, as well as buildings designed for occupancy by one to four families and transfers of vacant or unimproved land zoned for occupancy by one to four families. Except for a narrow list of exemptions, all sales under these categories would need to be reported, regardless of the purchase price.

The Real Estate Report assigns one person in the property transfer chain the responsibility for filing reports and recordkeeping, which could be the seller, purchaser, settlement agent, or attorney. Importantly, the rules allow contracting parties to enter into a written agreement designating who will file the report. This designation might, for example, be part of the purchase and sale agreement or escrow documentation and potentially serve to shift or limit liability. The filer must keep a copy for five years along with an attestation form executed by the transferee or transferee's representative certifying the accuracy of the beneficial ownership information.

In residential real estate sales, all parties involved, including sellers, developers, title companies, attorneys, and closing agents, need to be aware of reporting requirements. Consider a situation where a commercial developer builds a residential condominium building or build-to-sale single family community and subsequently sells-off residential units to individual buyers. If a condo unit or single-family home is bought with cash, such sale could trigger a filing requirement with FinCEN.

The consequences of failure to comply with these responsibilities are still unclear. The regulation, in its current form, does not impose direct liability. Instead, Treasury insists that the Real Estate Report would be used by FinCEN and other law enforcement agencies to investigate and prosecute money laundering under existing law.

KEY POINT

FinCEN's proposed rule would apply to various individuals and businesses involved in real estate, specifically those facilitating non-financed transfers of residential real estate property.

NOTES:

[1] https://public-inspection.federalregister.gov/2024-02565.pdf.

[2] https://home.treasury.gov/system/files/136/2024-National-Money-Laundering-Risk-Assessment.pdf.

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The U.K.'s Building Safety Act 2022: An Update

*By James Kane and Bonny Hedderly**

In this article, the authors examine one of the United Kingdom's most comprehensive reforms of building safety legislation in the last 50 years.

Nearly one year has passed since many of the principal measures in the Building Safety Act 2022 (BSA) came into force on October 1, 2023, in what was one of the most comprehensive reforms of building safety legislation in the last 50 years.

Participants in the property sector have now become well-acquainted with the requirements of the BSA and procedures for best practice are now emerging, along with some potential areas for difficulties. This article looks at the practicalities of registration of higher risk buildings, some areas of complication when identifying duty-holders under the BSA and the role of the managing agent in assisting with compliance. It also clarifies an area of concern relating to second staircases. The publication of the amendments to Approved Document B, clarifies that, from September 30, 2026, all residential buildings over 18 metres high must have two staircases.

REGISTRATION WITH THE BUILDING SAFETY REGULATORS

One of the key changes introduced by the BSA is the requirement for registration of a higher risk building with the Building Safety Regulator. Buildings that are at least 18 meters or seven stories high and contain two or more residential units will qualify as higher-risk buildings, subject to a few limited exceptions (hospitals, care homes, secure residential institutions, hotels, and military barracks).

Registration of a higher risk building with the Building Safety Regulator is a precondition to occupation. This caused concerns in the early days of the regime that a delay in effecting the registration of a higher-risk building could either delay occupation or completion of certain transactions where compliance with pre-occupation statutory requirements is a condition precedent to completion. We are pleased to report that in our experience most applications have been dealt with in a timeframe that can be measured in days rather than months, though developers need to ensure that this step is accounted for in their build programs, especially where any unexpected delays may have ramifications on the completion of transactions or stabilization of the asset.

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DIFFICULTIES IDENTIFYING THE PRINCIPAL ACCOUNTABLE PERSON

A potential difficulty when registering a higher risk building with the Building Safety Regulator is that the principal accountable person will need to be identified and named on the application form before an application can be lodged. To recap on the roles of the accountable person and the principal accountable person:

- Any person who holds a legal estate in possession of any common parts or who is under a repairing obligation in relation to any part of the common parts will be an accountable person in relation to a higher-risk building. The repairing obligation must either be imposed by statute or arise by virtue of being a party to a lease, which becomes important when we turn to the role of the managing agent later in this article.
- Where there are multiple accountable persons, the principal accountable person is the person who owns or has a legal obligation to repair the structure and exterior of the building. While there can be many accountable persons, there can only be one principal accountable person.

The identity of the principal accountable person is often evident for simpler ownership structures, though determining who fulfils this role can become complex in more convoluted ownership structures. As an example, the owner of a building may wish to create a structure under which a management company is responsible for the repair and maintenance of the structure of a building, though the building owner may be required to step-in to assume responsibility for repairs in case of default by the management company (and may have its own obligations under a headlease to keep the structure in repair). In these circumstances, the building owner may be keen to ensure that the management company is registered as the principal accountable person so that the onerous burden of compliance can be passed to the management company, though under the letter of the legislation this role may fall on the building owner regardless of their intentions.

A dispute as to the identity of an accountable person or a principal accountable person may be referred to the First-Tier Tribunal by any interested party, though questions of interpretation risk delaying the registration and hence occupation of higher-risk buildings. Parties to a development will therefore need to consider the identity of accountable persons at an early stage when creating more complex ownership structures in order to make sure that parties do not find themselves forced to accept onerous statutory duties against their intentions. The First-Tier Tribunal recently made its first decision as to the identity of an accountable person in *Octagon Overseas Limited and others v. Mr Sol Unsdorfer* and practitioners will be interested to see further cases emerge to provide much-needed assistance in resolving interpretative questions about the legislation.

THE ROLE OF THE MANAGING AGENT

Many building owners rely on managing agents appointed under a property management agreement to meet their statutory and maintenance responsibilities. A building owner may expect that the managing agent will discharge the statutory duties falling on account-

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able persons and principal accountable persons under the BSA as a part of their role. Here, a contrast needs to be drawn between the position under the BSA and under fire safety regulation, as a contractually appointed managing agent will not be an accountable person under the BSA (but may well be a responsible person under the Regulatory Reform (Fire Safety) Order 2005).

This means that while a managing agent can assist a building owner in meeting its obligations under the BSA, a building owner cannot delegate its statutory duties under the BSA. The consequences of a breach of these statutory duties will fall on the building owner even if the breach arose due to underperformance by the managing agent. The penalties for breach can be severe (including significant fines and potentially prison sentences) so building owners need to ensure they take an active role in ensuring their managing agents properly assume and fulfil the duties they are expected to take on under the property management agreement.

To ensure they fulfil their statutory duties, building owners who are accountable persons should raise questions about compliance with the requirements of the BSA at an early stage when appointing managing agents and thoroughly review a managing agent's credentials for taking on a role that includes ensuring BSA compliance. Market practice regarding compliance with these obligations is still emerging, so there is scope for disagreement as to what exactly the role of the managing agent should be in assisting with compliance with the BSA. As always, building owners should be clear about their expectations at an early stage in the tendering process to avoid surprises during negotiations with managing agents (such as requests for additional fees for assisting with compliance with duties under the BSA). The contractual documentation will need to allocate responsibilities clearly to ensure there is no uncertainty as to who exactly is required to take action to fulfil which duties to ensure no duties fall through the cracks, especially where there are multiple accountable persons.

BUILDING SAFETY ACT: ISSUE OF SECOND STAIRCASES

One particular area of concern relating to the BSA has been the position relating to the requirement for second staircases in tall residential buildings as developers were faced with uncertainty surrounding the technical requirements for second staircases to be built in tall residential buildings. The publication of the amendments to Approved Document B, clarifies that, from September 30, 2026, all residential buildings over 18 metres high must have two staircases.

The government had initially consulted on a requirement for second staircases in new residential buildings over 30 metres in December 2022; and there was some uncertainty as to when that took effect. The government then confirmed in July 2023 that the height limit would in fact be 18 metres (which is in line with the threshold for a "higher-risk building" under the BSA, but they did not issue any further guidance. This caused a huge amount of uncertainty with some schemes even being put on hold. In March 2024, the long-awaited amendments to Approved Document B: Fire Safety were published. This states that residential buildings over 18 metres in height should have more than one common stair. The guidance confirms that interlocked stairs (otherwise known as scissored or stacked

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stairs) count as one stair. The changes do not take effect until September 30, 2026.

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Wildfire Risk Scores and Insurance Placement: What Property Owners and Developers Should Know

*By Molly L. Okamura and Louis "Dutch" Schotemeyer**

In this article, the authors explain wildfire risk scores and discuss how they are calculated.

Wildfire risk scores are scores assigned to properties by third-party vendors based on the likelihood of direct or indirect exposure to a wildfire. Wildfire risk scores can be a factor used by insurance companies when making coverage decisions. Additionally, wildfire risk scores can be a helpful metric for real estate developers to consider when determining whether to buy a piece of property.

There are a variety of vendors that use unique methods to calculate wildfire risk scores. For example, CoreLogic, FireLine, and RedZone are vendors used by insurance companies in California. Some vendors' scoring scales are from 1-10, and some are from 1-100, but generally the higher the score, the higher the likelihood of a wildfire impacting the property. There is no national, standardized scoring scale.

The wildfire risk scoring system was originally designed to help property owners identify their likelihood of experiencing a natural disaster and take appropriate steps to mitigate damage. However, as damage from natural disasters became more extensive and costly, insurance companies began using wildfire risk scores as well.

Vendors calculate wildfire risk scores in various ways. They rely on satellite images of the property, census data, historic fire information, climate projection over the span of decades, and even simulated wildfires generated with artificial intelligence. Additionally, property data like vegetation, slope, access, fuel nearby, boundaries, and buildings are considered.

WHAT DO INSURANCE CARRIERS AND UNDERWRITERS USE WILDFIRE RISK SCORES FOR?

Insurance companies rely on wildfire risk scores to calculate the price of premiums. The higher the risk, the higher the premium. Underwriters also use wildfire risk scores to balance out the overall risk in their insurance portfolios.

Additionally, wildfire risk scores are considered when insurance companies decide whether they will cover or renew coverage on

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a property. If an insurance company thinks a wildfire risk score is too high - for example, if it increases following a fire in an area - they might discontinue coverage altogether. While many insurance companies rely on wildfire risk scores, some companies - like State Farm - have decided to simply stop providing coverage to new property owners in fire-prone areas in California.

Mitigating fire risk can be a critical part of ensuring the availability of insurance, particularly given the current market in California, which has seen some insurers refuse to write new policies or to renew older ones due to wildfire risks. Some developers are finding that their homebuyers are being forced, in high wildfire risk areas, to turn to the ever-growing FAIR Plan, which is the insurer of last resort in California.

WHAT SHOULD PROPERTY OWNERS KNOW?

The California Insurance Commissioner implemented a new regulation in 2022 that imposed requirements on insurance companies with respect to their use of wildfire risk scores. Under Cal. Code Regs., tit. 10, § 2644.9, subds. (d)-(k), insurance companies are required to:

(1) Provide insureds with their wildfire risk scores;

(2) Submit their wildfire risk score models to the California Department of Insurance;

(3) Provide discounts to property owners who take steps to mitigate the risk of wildfires; and

(4) Allow customers to appeal their wildfire risk score decision.

If property owners are in a fire-prone area or are assigned a high wildfire risk score, there are various mitigation measures they can take to reduce their premium. Under Cal. Code Regs., tit. 10, § 2644.9, subd. (d), insurance companies are required to consider the following mitigation efforts when calculating premiums: community-level mitigation efforts; property-level mitigation efforts, such as clearing vegetation and debris; and building hardening measures on structures like a Class-A fire rated roof, enclosed eaves, fire-resistant eaves, multipaned windows, and at least six inches of noncombustible vertical clearance at the bottom of a building.

There are other mitigation efforts that property owners can take, but insurance companies are not mandated to consider them. For example, the slope of the property relative to potential sources of ignition; accessibility of the property to firefighters; the direction of the slope relative to the direction of structures on the property; materials used in construction; and wind vulnerability may be considered.

If property owners are denied coverage or if they disagree with their wildfire risk score, Section 2644.9 allows them to appeal their wildfire risk score decision. However, the appeal is processed by the insurance company; the Department of Insurance is uninvolved. Therefore, if an appeal of a wildfire risk score decision is denied by an insurance company, the customer is essentially back to square one.

WHAT SHOULD DEVELOPERS KNOW?

Developers who are interested in buying property can obtain the wildfire risk score on it

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by reaching out to their insurance broker, who likely has an account with a vendor that provides wildfire risk scores. Alternatively, developers can create their own account with a vendor, then simply enter an address or latitude and longitude coordinates on the vendor's platform to receive a report with the estimated wildfire risk score for a property. If a developer has its own account, they can check the wildfire risk score on a piece of property regardless of whether they actually own the property yet. Accounts start at around $100 per month and reports start at around $2 each. Developers and builders should consider obtaining the wildfire risk score early in the due diligence process. We recommend talking with counsel early in the due diligence process when considering a land purchase.

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