horizon issues

Real Estate

Real estate counsel must master specialized and technical client concerns to stay on top of the latest market and regulatory developments. New government regulatory, tax and takings policies impact the fundamentals of mortgage lending and property investing, and add to the complexity of domestic and international projects.

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CONDEMNATION CLAUSES IN LEASES

Commercial real estate leases typically include boilerplate condemnation clauses covering the rights of lessors and lessees should the state, federal or local government condemn the property, either directly or through inverse/regulatory takings. To the extent they consider it at all, most lessees consider condemnation of a property a remote possibility and fail to protect their rights prior to lease inception.

In either a direct or inverse condemnation, the property owner is entitled to just compensation for the taking of the property; but unless stipulated by the lease's condemnation clause, tenants may be precluded from asserting a claim for just compensation for the taking of their property interests. An effective condemnation clause may provide possible relief. Certain condemnation clauses may preserve a tenant's right to seek recovery from the government for the value of its property affected by the government's actions, independent of the property owner's claim for just compensation for the taking of its property. Other clauses allow tenants to share in the property owner's award and may be drafted to compensate the tenant for certain damages and other losses that they may not be able to recover against the government.

A carefully drafted condemnation clause that stipulates compensation for the taking of tenants' property may give tenants, and not just property owners, an opportunity to receive just compensation for a taking.

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For more information on these lawyers and their firms as well as real estate analysis, please visit www.martindale.com and our Legal Articles database.

LIABILITIES IN PURCHASING CONDO DEVELOPMENTS

In Sunbelt states from Florida to California, condominium development purchases are highly regulated. Even sophisticated real estate developers who identify high-value transactions may not realize the cost of their legal obligations. Details vary by state, but these provisions of Florida's Condominium Act typify the traps for unwary investors in other states.

- Purchasers of bulk units who become successor developers of a condo development legally assume the condo association budget and any liability for budget shortfalls resulting from poor planning, excess unsold units or resident defaults on fees, which all can equal hundreds of thousands of dollars.
- A bank foreclosing on condo units is liable only for six months of assessments or an amount equal to 1 percent of the mortgage, whichever is less. The developer must pay the rest of the assessments, a huge cost in a development with many foreclosed units.
- The purchaser of a planned community who is assigned developer rights must assume control of the condo association and all its liabilities.
- The purchaser assigned developer rights also receives liability for all statutory warranties that include construction defects.
- In Florida and similarly in other states, statutes dictate how a condo developer must prepare the association budget, enforce covenants and assume liabilities, including compliance with a list of what the owner must provide when control finally reverts to the condo association, such as a full set of sealed engineering and construction plans.

Even if purchasers of condo developments rely on a condo management company to oversee their investments, the developer has the legal liability for all such regulatory requirements.

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HOUSING AND ECONOMIC RECOVERY ACT OF 2008: NEW REIT-RELATED PROVISIONS

The Housing and Economic Recovery Act of 2008 added new, and generally favorable, tax provisions affecting real estate investment trusts (REITs). Changes in the foreign currency area in particular follow the REIT industry's sustained efforts for more clarity in this area given its growing appetite for non-U.S. real estate investments. While the act created new opportunities for REITs, it also added new complexity.

Now "real estate foreign exchange gain" (REFEG) is excluded from gross income for purposes of both the 75 percent and 95 percent REIT gross income tests, whereas "passive foreign exchange gain" (that does not otherwise constitute REFEG) is excluded only for purposes of the 95 percent test. However, foreign currency gain derived from securities dealing does not constitute qualifying income for either test. Also, for purposes of the REIT asset tests, a REIT will not fail said tests due to a discrepancy in its foreign asset values caused solely by foreign exchange rate fluctuations and foreign currency used by a REIT or its "qualified business unit," except if held in connection with securities dealing, is treated as "cash."

Also under the act:

- "Hedging transaction" income excludable for purposes of the 95 percent gross income test (generally, income from a transaction that hedges debt incurred to acquire or carry real estate) is now also excludable under the 75 percent gross income test.
- Securities of taxable REIT subsidiaries may now constitute up to 25 percent (rather than 20 percent) of a REIT's total asset value.
- Prohibited transaction holding period "safe harbor" is shortened from four years to two years, and a 10 percent-of-aggregate fair market value alternative test is added for qualifying for safe harbor.
- Rental exception for qualified lodging facilities is extended to health care facilities.

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LAND OWNERSHIP AND DEVELOPMENT IN CHINA

Whether multinational corporations establish local operations or acquire established companies in China, legal due diligence is essential in any transaction involving land ownership rights. Under the Constitution and other laws, all land in China is owned either by the state or by agricultural collectives. Private entities, such as corporations and individuals, cannot obtain legal title to land, and only under certain conditions can they acquire the right to use land. Land in rural or suburban areas is generally collective-owned and cannot be used for industrial or commercial purposes. It cannot be developed unless it is converted into state-owned land and compensation is paid to the agricultural collectives for its conversion.

In recent years, however, village and township governments have developed much collective-owned land by erecting buildings, including residences, to be sold for profit. This is despite such statutes as the Urban and Rural Planning Law and the Land Management Law, as well as a December 2007 notice from the State Council, emphasizing that use of collective-owned lands by entities or individuals for real estate development is prohibited. Because the prices for illegal buildings are much lower than those for legally permissible developments, many citizens, particularly urban residents, take the risk and purchase these illegal structures. The situation has caused much debate, and many developers hope that new government policies will acknowledge the legal status of such property. Until then, American or other foreign businesses should closely investigate any representations made by sellers of property or structures that they are legally entitled to make such transactions.

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DATA CENTER DEVELOPMENT

Recent surveys indicate that perhaps one-third of companies use data centers—environmentally controlled, mission-critical structures containing corporate computer network servers—that are more than 7 years old and likely needing upgrades or expansion. Such potential demand has led many companies to undertake first-time construction and development of data centers.

Make these considerations when creating and operating these structures:

- **Site selection.** Account for adequate water availability (for cooling), local economic development incentives, climate change laws that may target data centers' large energy usage and resulting carbon footprint and the costs associated with operating in one site versus another.
- **Cost.** Consider electric power and overall facility costs (the enhanced need for security and proper cooling can run up to $1,500 per square foot). Since many costs will be passed to data center users, both parties need a very clear pro forma of the total operating costs and an understanding of the cost-controlling methodologies to be employed.
- **Data center management services.** Smaller facilities (under 10,000 square feet) are more likely treated as a full-service co-location offering by the data center owner in a multicustomer environment with an owner-managed shared infrastructure. Larger users may manage their own services, utilizing data center infrastructure on a nonshared basis. Inserting a service component is akin to an IT outsourcing agreement, so handle accordingly.
- **Design.** The basic design determines the best case level of operational certainty parties can hope to achieve. Parties then craft a maintenance model that takes fullest advantage of that design. Periodically implementing certain auditing standards (e.g., a Statement of Auditing Standards (SAS) 70 Type II audit for service organizations) ensures compliance with terms.

The lesson: Data centers are extremely complex, requiring substantial advanced planning to build and manage them successfully.

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NEW CONSUMER PROTECTIONS IN REGULATION Z

The Federal Reserve Board has adopted, under authority provided in the Home Ownership and Equity Protection Act (HOEPA), changes to Regulation Z to prevent unfair and abusive residential mortgage lending practices. The final rule, effective Oct. 1, 2009 (except for new property tax and insurance escrow requirements effective in 2010), makes three broad changes:

- Creates a new mortgage loan category called "higher-priced mortgage loans" (HPMLs) and increases their applicable protections. An HPML is defined generally as a loan secured by the borrower's principal dwelling having an interest rate that exceeds by a specified amount a new rate index that the Federal Reserve will publish. Most HOEPA loans (generally with higher rates or points and fees than HPMLs) will also get the added HPML protections.
- Provides additional protections for all closed-end mortgage loans (CMLs) secured by the borrower's principal dwelling regardless of interest rate, extends to all CMLs the requirement in Regulation Z to give early disclosures and prohibits lenders or brokers from collecting fees before borrowers receive early disclosures.
- Imposes new advertising requirements for all mortgage loans covered by the Truth in Lending Act that seek to eliminate misleading advertising practices regarding promotional rates or payment terms.

These new requirements largely codify changed practices and other new federal and state regulations and guidelines that reflect the dramatic decline in subprime and alt-A loans, where most abuses occurred. The biggest impact will likely be on misleading advertising practices that some mortgage lenders and brokers used to gain a competitive edge. Enforcement of the final rule's advertising restrictions, plus the potential for civil liability, should benefit both consumers and reputable lenders.

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