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in 32 jurisdictions worldwide

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CONTENTS

United States

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TRANSFER OF REAL ESTATE

1 Legal system

How would you explain your jurisdiction's legal system to an investor?

Other than Louisiana, which operates under a civil code, each state and the District of Columbia follow common law. There are three levels of laws in the United States – federal, state and local. An injunction may be obtained only upon a clear showing of harm when damages will not compensate the party seeking the injunction.

One circumstance in which New York courts have been known to issue injunctions (known as 'yellowstone injunctions') is in relation to cases in which a long-term lease provides that the term of the lease expires after the giving of a notice (generally a second notice). The harm would be irreparable. Accordingly, in such a case the court will enjoin the landlord from terminating the lease until the issues in dispute have been adjudicated. This action of the court is of particular significance if the transfer of the property is made pursuant to a long-term ground lease of the property rather than an outright conveyance, or if a purchaser of property is contemplating terminating a lease at the property based on alleged defaults by the tenant.

Courts in the United States normally take into account the behaviour of the parties. A party with 'unclean hands' is at a disadvantage.

Rules on parol evidence and requiring agreements to be in writing to be enforced vary from state to state. Courts will generally rely on the four corners of the document unless the intent of the parties is unclear. In New York, section 5-701 of the New York General Obligations Law provides that every agreement is void unless there is writing with respect thereto if such agreement is not to be performed within a year from the making thereof, subject to the exceptions set forth in such section. In general, contracts for the sale or transfer of real estate should be in writing.

2 Conveyance documentation

What are the legal requirements for documents recording conveyance?

Legal requirements for recording conveyance documents vary from state to state. Recordation is necessary to give notice to potential purchasers and other third parties of the ownership interests of real property. In New York, conveyances and mortgages are governed by article 8 of the New York Real Property Law. Article 8 prescribes authorisation when a grant takes effect and describes different types of deeds together with implied covenants thereunder. In general in New York, however, a conveyance of commercial property is made pursuant to a 'bargain and sale deed without covenant against grantor's acts' and a conveyance of a single residential property (eg, a condominium or a house) is made pursuant to a 'bargain and sale deed with covenant against grantor's acts'. Payment of fees in connection with the transfer of property varies not only by state, but by county as well. In order to transfer property in New York City, there is a New York City transfer tax in addition to a New York State transfer tax. The custom as to which party pays such taxes varies by jurisdiction and property type. As a very general rule, the seller pays transfer taxes, although in New York State, the purchaser of a single residential property (eg, a condominium or a house) for an amount in excess of US$1 million also pays a 'mansion tax' of 1 per cent of the purchase price. In addition, both the New York State tax and New York City tax are applicable to the sale of individual cooperative apartments, although such transactions are the transfer of shares in a cooperative corporation (rather than an direct interest in real estate). The New York State transfer tax is 0.4 per cent of the consideration in all cases. The New York City transfer tax varies by property type and amount, but for commercial transactions in excess of US$500,000, the tax is 2.625 per cent of the consideration.

There are methods to minimise taxes in some jurisdictions, where, for example, parties often acquire the ownership interests (eg, shares (for corporations), membership interests (for limited liability companies) and partnership interests (for partnerships)) of the owning entity as opposed to the property. Some jurisdictions, however, including both New York State and New York City, impose a tax on the transfer of ownership interests in entities that own real estate in the same manner as transfers of real estate.

In most states, the deed must be acknowledged or notarised and presented to the local government recording office. In a few states, the 'Torrens' system of title registration is still used. Most jurisdictions impose a recording fee (in addition to any transfer tax) to record the deed. Again, the custom as to which party pays such recording fee varies by jurisdiction and property type.

3 Foreign investors

What other factors should a foreign investor take into account in considering an investment in your jurisdiction?

There are few, if any, controls prohibiting a foreigner from owning real property in the United States. The one limitation that still exists in certain states pertains to ownership of US agricultural and natural resources.

Reporting is required for foreign persons who:

- purchase (directly or indirectly) at least 10 per cent of a US business (including real estate ownership), who must file a private report within 45 days (in addition to possible quarterly and annual reports) with the bureau of Economic Analysis of the US Department of Commerce (under the International Investment Survey Act (the International Investment and Trade in Services Survey Act) of 1976) though exemptions are available in certain cases;
- purchase or transfer US agricultural land, who must file a public report within 90 days with the secretary of agriculture (under the Agricultural Foreign Investment Disclosure Act of 1978);
- hold any direct US real estate investments valued over US$50,000 during the previous calendar year, who must file an information return (under the Foreign Investment in Real Estate Property Tax Act of 1980, which also subjects any income of the foreign investor from US real estate transactions to federal taxation); and

- control a domestic or foreign corporation – the corporation must file an information return annually with the Internal Revenue Service (IRS) (under the Tax Equity and Fiscal Responsibility Act of 1982).

Additional reporting may be required under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, the Internal Revenue Code and Executive Order No. 13224 on Terrorist Financing, effective 24 September 2001, and relating to Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism and the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the Patriot Act).

4 Exchange control

If a non-resident invests in a property in your jurisdiction, are there exchange control issues? What about repatriation of capital?

There are no exchange control issues in the United States. Capital can be repatriated, subject to withholding of funds to pay US taxes if the seller of property or entities in lieu thereof is not an effectively connected US taxpayer or a citizen of a country that has a tax treaty with the United States. The US Internal Revenue Code generally provides for a withholding (at the closing of the sale of the real property) of a portion (10 per cent) of the sale proceeds from the sale of real property by a non-US taxpayer, subject to a subsequent reconciliation when the non-US taxpayer files its tax return with the IRS. The IRS also provides a pre-closing procedure pursuant to which the non-US taxpayer may obtain the determination of the IRS as to the actual tax that will be due on the sale, in which event the amount of such tax will be required to be withheld.

5 Legal liability

What types of liability does an owner of real estate face? Is there a standard of strict liability and can there be liability to subsequent owners? What about tort liability?

An owner of real estate can face several types of statutory and contractual liability as owner, seller or lessor. Federal and state-mandated liability includes environmental and tort liability. Under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), the buyer of real estate that is contaminated by hazardous substances is liable for the clean-up, even if the buyer did not participate in the contamination. In all the CERCLA defences, the new owner is expected to have performed due diligence and made all the appropriate inquiries (as standardised by the US Environmental Protection Agency). Other federal and state environmental laws, however, do not limit the new owner's liability by accepting the defence that it was not the owner at the time of contamination. In addition, if a mortgage lender involves itself too closely in the disposition of hazardous materials on a borrower's property, the mortgage lender may become liable for any liabilities or damages that result from the disposition of such hazardous materials.

In the case of leases, landlords can face additional liability for failure to: disclose defects or dangerous conditions known to the landlord, provide a new construction that is fit for the purposes intended (when leases are executed prior to completion of construction), provide a fit, habitable and tenantable dwelling in urban areas (under common law), repair and maintain the premises (if so contracted by the parties), or provided essential services such as heat, water or hot water.

In the case of a contract of sale, a seller typically makes certain representations and warranties to a purchaser. A seller may sell 'as is' and with appropriate disclaimers, and put the burden on the purchaser to determine it is satisfied with the existing state of facts. If the purchaser asks a question, such as whether there is asbestos on the property, and the seller does not tell the truth, such fraud is actionable after conveyance of title. As a general rule, in the absence of a statement to the contrary in the purchase contract, representations and warranties do not survive conveyance.

Some states and municipalities also have requirements that the seller of a single residential property (eg, a house or a condominium or cooperative apartment) make certain required disclosures about the condition of the property, including the presence of asbestos-containing materials, lead paint and radon.

An owner of property is liable to third parties, invitees or otherwise, for a tort that occurs on their property. A contractor (and the employees of a contractor) or a visitor may make a claim for damages suffered in an accident that occurs on the property of another. In New York, the owner of a property, and its contractor, face strict liability if an employee of a contractor is injured from a fall from scaffolding (in some cases, even if the employee was at fault).

6 Protection against liability

How can owners protect themselves from liability and what types of insurance can they obtain?

An owner can best protect itself from environmental liability by doing due diligence on the property, preferably pre-ownership. Environmental insurance is available, even in the case of contaminated property. However, environmental insurance policies contain many restrictions and limitations that effectively limit recovery under such policies, and the premiums for such policies can be high.

In terms of other types of liability, care should be given as to the type of entity owning the property and coverage of adequate insurance. Insurance is generally available in the United States to cover property damage, liability, indemnity coverage, construction risk coverage and rent loss coverage, among others. Care should be taken to work with a professional insurance consultant as scope of coverage and deductibles vary widely.

7 Choice of law

How is the governing law of a transaction involving properties in two jurisdictions chosen? What are the conflict of laws rules in your jurisdiction?

Each state has its own laws regarding conflicts of laws. Many states look to the various 'contacts' to the state in question (eg, the locations of the parties to the transaction and where the contract was negotiated and closed) in determining whether a transaction has a nexus in their state. New York adopted a statute that permits parties to choose New York as a governing law jurisdiction and the New York courts as the forum to adjudicate disputes under their contracts.

With respect to real estate, as a general rule, the safer practice will be to have a real estate contract (particularly a lease or mortgage loan documents) governed by the law of the state in which the subject property is located, because most states have detailed statutory provisions and case law governing the interpretation of enforcement of documents that relate to the ownership, leasing and mortgaging of property located in that state. So, for example, foreclosure of a mortgage or deed of trust should be governed by the law of the jurisdiction in which the property is located. It is not as critical in the case of a contract of sale, although the ability of a purchaser to record a lien on the subject property following a default by the seller under the contract will be governed by the law of the jurisdiction in which the property is located.

It has become relatively common in mortgage loan transactions involving out-of-state lenders to provide that the loan documents are governed by New York law, in order for the lender (and investors in securities backed by the loan) to have some uniform understanding of the legal regime governing documents. Because the creation and perfection of mortgage liens and the enforcement of mortgage liens are governed by the law in which the property is located, however, most of these loan documents provide that such local law will govern the creation, perfection and enforcement of the mortgage liens. At closing, the borrowers will provide the lenders with opinions of both New York counsel and counsel from the local jurisdiction covering the portions of the loan documents governed by the laws of their respective jurisdictions.

8 Jurisdiction

Which courts have subject-matter jurisdiction over real estate disputes? Which parties must be joined to a claim before it can proceed? What is required for out-of-jurisdiction service? Must a party be qualified to do business in your jurisdiction to enforce remedies in your jurisdiction?

Courts will require a nexus with a case to take jurisdiction. In the case of federal laws, a party may seek 'diversity jurisdiction', meaning that if parties to the dispute come from different state jurisdictions, either party may commence the action in a federal court located in the state in which either party is located or, if one of the parties has commenced an action in the courts of the state in which such party is located, the other party may seek removal of the action to a federal court in the state in which the action was commenced or in the removing party's jurisdiction.

Necessary parties will vary with the type of transaction. In a foreclosure action, local statutes will require that 'required parties' (usually the parties that have an interest in the property, including, lien holders and tenants) be joined in order to clarify their rights.

States have individual rules for out-of-jurisdiction service. Counsel often make provision in contracts that the parties submit to the laws of a particular jurisdiction and, if necessary, provide an agent for service of process in the chosen state.

Most states have a statutory requirement providing that a party must be qualified in the state in order to enforce remedies in the courts of the state.

9 Investment entities

What legal forms can investment entities take in your jurisdiction? Which entities are not required to pay tax for transactions that pass through them (pass-through entities) and what entities best shield ultimate owners from liability?

States recognise a broad spectrum of entities – C corporations (for publicly held corporations), S corporations (for privately held companies), partnerships (both general and limited), limited liability companies, trusts and individual ownership.

Partnerships, limited liability companies, and trusts are pass-through entities for tax purposes, as are S corporations (although some jurisdictions, such as New York City, do not treat S corporations as pass-through entities for tax purposes). S corporations should generally not be used for real estate investments, however, owing to limitations on the ability to take depreciation deductions.

Our choice for limitation of liability is limited liability companies (by statutes) and trusts. Limited partnerships shield limited partners, but may impose fiduciary duties upon partnership decisions (particularly to the general partners of the limited partnership). C corporations also afford limited liability (but do not provide that tax pass-through benefit, so that income would be taxed on both the corporation and, to the extent of any dividends that are paid, the shareholders).

10 Foreign investors

What form of entities do foreign investors customarily use in your jurisdiction?

US investors generally use limited liability companies and limited partnerships. Those structures are preferred by foreign investors owing to the tax pass-through aspects as well as liability protection. For foreign investors, the form of entity will depend on tax treaties. European investors generally invest through limited liability companies. Investors from the Middle East generally have to deal with shariah issues and structure transactions so that interest is not paid. Their investment may be through a lease. Individual investors into the United States often use limited liability companies or limited partnerships (if these structures work well with the tax regime of the investor's home country and the home country's tax treaty with the United States), C corporations (which are less frequently used since there is no tax pass-through) or trusts. Foreign investors frequently hold their limited liability companies and limited partnerships through offshore companies organised in favourable tax jurisdictions.

11 Organisational formalities

What are the organisational formalities for creating the above entities? What requirements does your jurisdiction impose on a foreign entity? What are the tax consequences for a foreign investor in the use of any particular type of entity, and which type is most advantageous?

Limited liability companies and limited partnerships must file formation documents. New York also requires publication in New York newspapers of the notice of the formation of a limited liability company for both New York entities and foreign entities doing business in New York. Failure to do so may result in loss of limited liability protection. Formation documents must also be filed for foreign limited partnerships doing business in New York.

A corporation owning real estate will subject an owner to two levels of taxation. First, tax on the earnings from the real estate will be borne by the corporation and, second, tax on dividends to the shareholders from the corporation will borne by the shareholders.

A limited liability company or a limited partnership will be subject to only one level of taxation – there will be no taxes to be paid by the limited liability company or limited partnership in respect of the earnings from the real estate, and each member of a limited liability company and each partner of a limited partnership will be taxed on its pro rata share of such earnings (whether or not all of such earnings are actually distributed by the limited liability company or limited partnership to its owners).

Since we generally recommend that an entity own only one property, capital gains from the property may be offset by capital losses in another if the property entities are owned by a single entity. There are limitations on the ability to offset ordinary income with capital losses.

Trusts may be structured to result in only one level of taxation and shield the individual(s) from paying estate taxes in the United States.

The efficacy of the structure for foreign investors will depend in large part upon the tax laws of their home jurisdictions and the tax treaties such jurisdictions have with the United States.

12 Documentation

Is it customary in your jurisdiction to execute a form of non-binding agreement before the execution of a binding contract of sale? Will the courts in your jurisdiction enforce a non-binding agreement or will the courts confirm that a non-binding agreement is not a binding contract? Is it customary in your jurisdiction to negotiate and agree on a term sheet rather than a letter of intent? Is it customary to take the property off the market while the negotiation of a contract is ongoing?

Letters of intent are frequently used in the United States. They serve the purpose of spelling out major terms of transactions (subject to due diligence). They are not generally used in connection with financings, rather, in connection with financings the parties will typically negotiate a term sheet outlining the general terms of the transaction. The detail and scope of a term sheet vary from lender to lender.

Letters of intent generally provide for protection against brokerage claims and indemnify an owner for any harm that may be caused by the entrance of a prospective purchaser onto the property for the purpose of conducting due diligence (eg, environmental examinations). The typical letter of intent will provide for survival of such provisions, notwithstanding the fact that the transaction may not occur.

A purchaser will typically ask the seller to take the property off the market for an agreed period of time, sufficient to permit the purchaser to complete its due diligence.

The letter of intent typically permits the purchaser to terminate the letter of intent. The seller may ask for a deposit. Much of the leverage of the parties will depend on the market.

As a note of caution, however, a letter of intent must be carefully drafted to avoid having it constitute a binding contract of sale. There have been cases, including in New York, in which the provisions of a letter of intent and the conduct of the parties in respect of the letter of intent persuaded a court to rule that the letter of intent constituted a binding contract.

13 Contract of sale

What are typical provisions in a contract of sale?

A typical contract of sale will set up the mechanics of the closing as well as the conditions and actions that must be satisfied or occur between the date of signing and closing.

The contract will first describe the property, including a metes and bounds legal description, together with all items to be transferred to the purchaser, such as appurtenances, personalty, leases, easement rights, and so on. The contract will set out the price for the property, the down payment (which will customarily be held in escrow with the seller's counsel or a title company) and adjustment for taxes, rents assessments, etc. It will also provide for remedies for breaches by seller or purchaser. The seller will attempt to limit damages if it defaults to the return of the down payment. The purchaser will want to be able to specifically enforce the performance by a defaulting seller, but it is likely that a court will order damages instead. Most contracts will provide that, if a purchaser defaults, its liability will be limited to the forfeiture of its down payment.

The contract will contain representations by the parties. The purchaser's representations will generally deal with its organisation and authorisation to enter into and close the transaction. The seller's representations will also cover organisation and authorisation as well as property specific representations and covenants, although most sellers will attempt to limit the scope of the representations. A purchaser will typically request representations about leases (including, for example, that true and complete copies of the leases have been delivered; that a true and complete copy of the rent roll is annexed to the contract; that the tenants are not in default under their leases; and that security deposits (in the amounts listed on the rent roll) are held by the seller), representations dealing with physical condition of the building and environmental issues. The seller's covenants will deal with the seller's operation of the property between contract and closing. The purchaser will want to be certain that the building will be properly maintained and that there will be no material changes to the property – particularly, no new leases (or modifications of leases) or property management agreements without the consent of the purchaser. The purchaser will want the contract to provide that a condition to the obligation of the purchaser to close under the contract will be that the seller's representations and warranties are accurate in all material respects and that the seller has complied with its covenants.

The contract will also provide whether and to what extent the representations of the seller will survive the closing. The purchaser will typically want the representations to survive for six months to a year, and the seller will typically want its post-closing liability for the representations to be limited to a short period of time and to a stated cash amount (which in some cases will be held in escrow until the expiration of the survival period).

The contract will also address which party bears the risk of loss between contract and closing. It will also deal with continuation or termination of management and services agreements. The seller typically bears the risk of loss for major casualties with insurance proceeds. Purchasers will rarely take any risk of a condemnation.

Regarding title insurance, the contract will typically provide that a purchaser may purchase an examination of title and title insurance at its own expense (although in some jurisdictions the custom provides for the seller to bear a portion of the cost). The seller will usually not make any title representations because nearly every purchaser obtains title insurance. The contract will also typically provide that a condition to the closing is that the title insurance company will insure that the subject property is not encumbered by any easements, covenants or other matters, except for the items listed on an exhibit to the contract (which will list the easements, covenants or other matters of which the seller is aware) and that the seller will be obligated at its expense to remove its mortgage liens, liens for past due taxes and mechanics' liens from contactors.

14 Environmental clean-up

Who takes responsibility for a future environmental clean-up? Are clauses regarding long-term environmental liability and indemnity that survive the term of a contract common? What are typical general covenants? What remedies do the seller and buyer have for breach?

Responsibility for environmental clean-up will be allocated in the contract. For example, if a property is part of a governmental clean-up plan, the seller will want to have the purchaser deal with the clean-up. Most buyers prefer to wait until any known environmental matters are resolved. If a project is on a brownfield site, or if a purchaser has found concerns in a Phase I environmental search (which we recommend that all purchasers obtain), the purchaser will want to specifically address the issues raised, with any representations surviving the closing. If any remediation needs to be done, the purchaser should hold back a portion of the purchase price in escrow. Frequently, the purchaser will want the contract to provide that the purchaser may conduct environmental due diligence within a finite period (eg, 30 or 60 days) after the execution of the contract and, if the purchaser is not satisfied with the results of its environmental due diligence, the purchaser will have a right to cancel the contract. The seller will typically agree to such a provision and limit any representations to matters within the seller's knowledge. The seller will usually prefer such a provision rather than retaining any significant exposure for any environmental matters following the closing or proceeding to closing, with the purchaser having a right to hold back a portion of the purchase price for remediation.

The seller will want to restrict any environmental representations being to its knowledge only. The survival of the environmental representations will usually be addressed with the survival of the other representations (see above), but, as noted above, the seller's representations will usually be limited to the seller's knowledge, not the actual existence of environmental contamination.

If a clean-up needs to occur, a purchaser will want not only covenants with respect to the seller's obligations, but also copies of the documents from local, state and federal authorities confirming that these authorities have determined that the clean-up has been completed to the satisfaction of these authorities. As noted above, however, the seller will generally prefer that the purchaser satisfy itself in respect of any environmental matters prior to closing, rather than having the seller retain any environmental obligations following the closing.

The purchaser (and its lender) may want to obtain environmental insurance.

Regarding the remedies for breach of environmental representations, the contract will usually provide that the purchaser will not be obligated to close if the seller's representations are untruthful and incorrect as of the closing, and if seller breaches any environmental representations that survive the closing. There is typically a maximum amount set aside at closing or otherwise provided to cover the breach of any surviving representations. If no amount is set aside, the purchaser would have the right to commence an action for damages arising out of the breach of representation. If no funds are set aside at closing, the purchaser should require that the seller's surviving representations be guaranteed by a creditworthy entity.

15 Lease covenants and representation

What are typical representations made by sellers of property regarding existing leases? What are typical covenants made by sellers of property concerning leases between contract date and closing date? Do they cover brokerage agreements and do they survive after property sale is completed? Are estoppel certificates from tenants customarily required as a condition to the obligation of the buyer to close under a contract of sale?

Purchasers will want expansive representations concerning leases, including that:

- the seller has delivered to the purchaser complete copies of all of the leases;
- annexed to the lease is an accurate rent roll for the property;
- the leases are in full force and effect;
- there does not exist any default by either landlord or tenant under the leases;
- all brokerage commissions in respect of the leases have been paid; and
- the seller (as landlord) has completed all tenant improvements required of the landlord under the leases and the tenants have accepted such tenant improvements as complete.

The purchaser will want to know the tax and operating expense bases under the leases. The seller will resist having the representations survive the closing (see above for a discussion of the survival of seller representations). The purchaser will want to receive estoppel certificates from the tenants, confirming the representations that the seller has made. If any brokerage commissions are scheduled to be paid following closing or any tenant improvements will not be completed by the closing, the parties will negotiate the extent of the responsibility of each party with respect to such matters, which may result in an adjustment of the purchase price.

It is a major part of the negotiation between the seller and the purchaser as to how many estoppel certificates must be delivered as a condition to the obligation of the purchaser to close (and, in any event, the purchaser's lender will typically insist on a certain level of estoppels as a condition to the funding of the acquisition loan). If less than 100 per cent is required, the seller is usually required to obtain estoppels from the major tenants and tenants that occupy, in the aggregate, a specified portion of the square footage of the property. The seller will want to be released from its obligations with respect to leases for which the purchaser has estoppel certificates.

The rent stream is the heart of the value of the property, and this will be one area where the purchaser will want comfort in knowing what it is getting.

The contract will also usually provide that, between the execution of the contract and the closing, the seller will not, without the consent of the buyer, execute new leases or amend or terminate existing leases, or execute any brokerage agreements for leases and that the seller will comply with its obligations as landlord under the leases, including the completion of any tenant improvement work required to be performed by the landlord.

16 Leases and mortgages

Is a lease generally subordinate to a mortgage pursuant to the provisions of the lease? What are the legal consequences of a lease being superior in priority to a mortgage upon foreclosure? Do lenders typically require subordination and non-disturbance agreements?

This is an issue for leases that predate a mortgage. A lease executed after the mortgage will be subordinate to the mortgage.

Most owners include provisions in their standard form of lease that the lease is subject and subordinate to mortgages and ground leases (whether such mortgages and ground leases are executed before or after the lease). All tenants want to be certain that if the mortgage is foreclosed, they will be able to remain in the demised space on the terms and conditions of the lease (provided that they are current in their lease obligations). Small tenants can rarely obtain such protection if leases have the automatic subordination language described above. In a large lease, the protections to the tenant can become a major negotiation. In some cases, particularly in shopping centre leases, tenants will want to provide that their leases are superior to the mortgages. They are often successful. Lenders generally require that subordination and non-disturbance agreements (SNDAs) be in place with the major tenants. In exchange for the subordination, the tenant gets protection that its occupancy can continue without being interrupted, provided that the tenant is not in default under its lease obligations. Major tenants (particularly national or regional retailers) will frequently heavily negotiate the lender's form of SNDA or provide their own form of SNDA.

SNDAs typically require that the tenant attorn to a new landlord and provide that the new landlord does not have liability for defaults by the previous owner. Tenants will want to provide that they will not be joined in a foreclosure or other mortgage enforcement action. In many cases, the tenant will require that the new landlord complete any tenant improvement work that the prior landlord failed to complete. Estoppel certificates do not take the place of SNDAs.

17 Delivery of security deposits

What steps are taken to ensure delivery of security deposits to a buyer? How common are security deposits under a lease? Do leases customarily have periodic rent resets?

Buyers (as well as their lenders) will carefully monitor delivery of security deposits. Cash is easy to deliver (or the seller will retain the security deposits and provide the purchaser with a credit against the purchase price in the amount of the security deposits). Letters of credit, which, by their terms are assignable, are easier to transfer, and the transfer should be completed as a condition to the closing. In cases where letters of credit are not transferable, new ones should be obtained as a condition to closing. Lenders are likely to require that cash deposits be placed in secured accounts.

Unless a tenant is a creditworthy entity or has a creditworthy guarantor, a landlord is likely to require a security deposit. The amount will depend on the particular circumstances. Many landlords prefer that a significant security deposit be provided in the form of a letter of credit on the theory that, if a tenant files for bankruptcy, the security deposit of such tenant will be subject to the restrictions of the bankruptcy court but that the letter of credit, which represents the obligations of the issuing bank, will not be subject to the restrictions of the bankruptcy court.

Rent resets are common for extension terms. However, landlords will often try for, and get, periodic rent resets during the base term of the lease. Such provisions generally contain downside protection for the landlord (that is, a provision that rent will not be reduced even if the market rent is lower than the rent currently paid) and upside protection for the tenant (that is, a limit on the amount by which the rent may be increased, regardless of the actual level of market rents). In any reset, counsel should pay particular attention to operating expenses and tax payments.

18 Due diligence

What is the typical method of title searches and are they customary? How and to what extent may acquirers protect themselves against bad title? Does your jurisdiction provide statutory priority for recorded instruments?

It is customary to conduct Uniform Commercial Code (UCC), judgment and bankruptcy searches against the borrower, and any guarantors, members and partners of the borrower, particularly a controlling member or general partner. Such searches are done by search service companies.

In the United States, title insurance companies search title to real property and write insurance to guarantee title for both the owner and the lender. Counsel do not generally do title searches (except for certain jurisdictions in which counsel are permitted to act as title agents).

As noted above, because nearly every purchaser obtains title insurance, purchase contracts usually do not contain title representations.

In New York, the general rule is that the priority of a recorded document depends on the order of recording (ie, first recorded is first in priority).

Some, but not a majority of jurisdictions, such as Massachusetts, have a 'Torrens' recordation system. This type of system 'registers' title, so priority is ensured. That is not the case in other US jurisdictions. For that reason, the title insurance industry has evolved in order to provide insurance to purchasers and lenders.

Opinion letters are customary in virtually all transactions. They generally deal with authorisation and enforceability of documents. They may also address other issues (eg, particularly securitisation transactions, bankruptcy non-consolidation of the borrower with the parent company and certain other affiliates of the borrower). Opinions rarely cover title or the priority of mortgage liens.

19 Structural and environmental reviews

Is it customary to arrange an engineering or an environmental review? What are the typical requirements of such reviews? Is it customary to get representations or an indemnity? Is environmental insurance available? Is it customary to obtain a zoning report or legal opinion?

It is customary either to have an engineering company review a property or for large companies with construction capability to do their own review. Each acquirer determines the detail of inspection.

A 'Phase I' (meaning checking prior uses and environmental data basis and observing the property) is always done. Particular attention should be paid to any property that has (or had) asbestos or underground storage tanks. Unless some type of problem is found, more diligence will not usually be required. If there is any indication of a problem, a 'Phase II' will be done, which will entail some testing of the soil or water, or both, for potential contamination. The Phase I and Phase II reports are prepared in a standardised format.

A purchaser's ability to get representations concerning environmental matters will depend, in part, on the strength of the market. Environmental representations are generally avoided by sellers and the representations they may give are in regard to their knowledge only. Nevertheless, because most purchasers acquire properties with acquisition financing, and because nearly all lenders require at least a satisfactory Phase I, a seller will typically permit a potential purchaser to conduct a Phase I search within a finite period following the execution of a contract.

In mortgage loan transactions, it is customary for the borrower to make environmental representations regarding the mortgaged property and for the principals of the borrower required by the mortgage lender (usually the principals that have financial wherewithal) to execute an environmental indemnity agreement in favour of the mortgage lender, pursuant to which such principals indemnify the mortgage lender against loss and damage arising from environmental issues affecting the mortgaged property.

As noted above, environmental insurance is available in the United States, subject to the limitations of the coverage. A mortgage lender will also require the borrower to obtain an environmental insurance policy if the mortgaged property has a history of significant environmental problems (eg, a former industrial site or a brownfield property).

It is also worth noting that many lenders have in recent years required borrowers to obtain zoning reports from companies that specialise in preparing reports of the zoning status of the property. If a property is not in compliance with zoning limitations as to height and bulk, and if a fire or other casualty then occurs, the owner of the property may not be able to rebuild the property to its pre-casualty size and configuration. In addition, the zoning ordinance will also prescribe what types of uses are permitted at the property, and a purchaser or lender will want to verify that the property is being used only for the permitted uses.

It is customary for a lender to require that a borrower provide a legal opinion of counsel in connection with the closing of a financing transaction. Such legal opinion will typically include opinions with respect to the formation and good standing of the borrower entity, corporate power and authority to enter into the transaction, no conflict with the borrower's organisational documents, no outstanding litigation against the borrower that would affect the borrowers ability to enter into the transaction, legal enforceability of the principal transaction documents, and such other matters as such lender may require.

20 Review of leases

Do lawyers usually review leases or are they reviewed on the business side? What are the lease issues you point out to your clients?

Leases are often reviewed by counsel. Prospective purchasers and lenders are concerned about termination rights in leases and unfulfilled landlord obligations. Clients want to confirm that the business points indicated in the rent roll provided by the seller or the borrower, such as rents, tax and operating expense stops, lease term and renewal term, security deposits, etc, are as expected. A prospective owner or lender will also want to check rent abatement periods. Since the terrorist attacks of 11 September 2001, more attention has been given to condemnation and casualty clauses. Owners and lenders have realised how long it takes to make repairs. Tenants have learned how hard it is to have to rent temporary space for any significant period of time. In addition, lenders will want to examine the subordination provisions of the lease or determine that the lease does not contain any subordination provisions. Transfer and assignment clauses also need to be carefully reviewed, as do use clauses. Counsel reviewing leases need to be certain that restrictions as to use in one lease do not become an impediment to another lease in the future. This latter point is particularly important in leases for retail properties as many 'anchor' tenants and other major tenants require the landlord to limit the number of competitor tenants at the property.

We generally prepare abstracts of leases to point out salient items to prospective owners or lenders.

21 Other agreements

What other agreements does a lawyer customarily review?

Lawyers customarily review title reports, including underlying encumbrances on title, such as easements, reciprocal easement agreements, restrictive covenants, condominium declarations, development agreements, and so on. Lawyers check legal descriptions against surveys, which should be checked to confirm access from the property to public roads, that no easements run under buildings and that there are no encroachments by buildings on the property onto adjacent properties or by buildings on adjacent properties onto the subject property. Lawyers check certificates of occupancy or evidence of zoning and building permits if buildings have not been completed.

In addition to reviewing leases, lawyers review management agreements. Management agreements for most asset classes need to provide that a lender foreclosing on the property may terminate the management agreement. In hotel property transactions, the attorney will need to very carefully review both the management agreement and the franchise agreement (ie, the agreement that provides the 'flag' to the hotel). Both of these agreements will contain restrictions on the ability of the owner or lender to terminate the agreement, and purchasers and lenders typically enter into lengthy negotiations with the management company and franchisor as to the relative rights and obligations of the parties.

In terms of service contracts, a lawyer's main concern is that the contract may be terminated on 30 days' notice without the payment of any fee or other compensation.

Brokerage agreements should be checked to be certain that no fees are payable.

In hotel acquisitions and in the acquisition of office and multi-family housing in urban areas, lawyers will check to determine whether any union agreements are involved and to review these agreements.

22 Closing of transaction

How does a lawyer customarily prepare for a closing?

Much of what a lawyer must do has been set forth in the contract, which will contain a list of deliverables, including the type of deed and any bill of sale as well as conditions to closing.

After the contract is signed, the lawyer will complete any remaining due diligence. The lawyer will ensure that leases, contracts, management agreements and franchise agreements will be assigned. The lawyer will coordinate delivery of original leases, keys and other required documents. The lawyer will also have to coordinate lender requirements and negotiate loan documents.

For example, the survey will need to be certified to the new owner, the title company (for the lender and the owner) and the lender. A satisfactory title insurance policy will need to be delivered to both the new owner and the lender.

The lawyer will generally review the organisational documents and authorising resolutions of the seller, purchaser or borrower to confirm the opinions given. The lawyer will also obtain for a seller, purchaser or borrower, from the secretary of state of the entity's organisation and the secretary of state in which the property is located, a certificate of good standing and a certified copy of the certificate of incorporation, certificate of formation or certificate of limited partnership.

Deliverables should include evidence of payment of real estate taxes and water bills; any warranties, deeds, bills of sale, assignments of leases, contracts and permits and other property-related documents. Payment of transfer, recording taxes and mortgage taxes should be arranged for.

While it is customary to prorate property expenses (eg, taxes and utilities) as of the closing date, it is not always possible to do so and there may well be provision for post-closing items. The prorations for a hotel property are generally more complex since the hotel is an operating business with many more expenses (eg, employee costs) and revenues (guest bookings) to prorate. In addition, assessments may be levied post-closing. While those are customarily absorbed by the purchaser, that provision can be negotiated.

FINANCING

23 Form of lien

What is the method of creating and perfecting liens?

The form of lien is determined by state law. There are two general categories. States such as New York are lien theory states and mortgages are the customary form of lender lien document.

States such as California are deed states. Deeds of trust provide that title is conveyed to a trustee to be held for the benefit of the lender or beneficiary. Upon repayment of debt, title must be reconveyed.

The effect is ultimately the same. The proper recordation of the mortgage or the deed of trust in the public recording office creates a security interest for the benefit of the lender. In most other respects, the documents are generally identical in scope and coverage.

Virtually every other type of security interest is governed by the Uniform Commercial Code (UCC), which was revised in 2006 and has been adopted in virtually every state. While states enact variations, in general the UCC provisions are substantially similar in each state. Security interests in accounts are now perfected by control agreements. Security interests in personalty and intangibles are perfected by filing of UCC-1 financing statements. Security interests in certificated securities may be perfected by possession of the certificates by the lender or by the filing of UCC-1 financing statements. UCC-1 financing statements are filed with the secretary of state of the state in which the borrower entity was organised.

24 Legal requirements

What would be the ramifications of a lender from another jurisdiction making a loan secured by collateral in your jurisdiction? What is the form of lien documents in your jurisdiction? What other issues would you note for your clients?

Lenders that are not qualified to do business in states in which the mortgaged property is located will, as a general rule, have to qualify to do business in such state. Such qualification would subject a lender to the payment of taxes in such jurisdiction to enforce remedies. At the time a loan is made, many states have a 'foreign lender' exemption, permitting lenders that are not qualified to do business to make occasional mortgage loans. As a matter of practice, a lender will generally take title to the property in the name of a wholly owned (or jointly owned in the event that there is a syndicate of lenders) subsidiary. That is done both for the purpose of limiting liability and to isolate taxes incurred solely to the asset in such states. (Note that states such as California have unitary taxes, which purport to tax a portion of a parties' overall income).

New York is a lien theory jurisdiction and the type of security instrument is a mortgage. There are significant recording taxes (most large commercial mortgages in New York City are subject to a tax of 2.8 per cent of the mortgage amount), but existing mortgages may be assigned to a new lender without payment of further taxes (up to the amount of the original debt that remains outstanding). Mortgages held by affiliates of the borrower are considered to be 'warehoused' and do not preserve taxes paid. A mortgage that is assigned to a new lender may be consolidated with a new mortgage made by the new lender into a single consolidated mortgage without the payment of additional tax (although a tax will be imposed on the new mortgage made by the new lender).

25 Loan interest rates

How are interest rates on commercial and high-value property loans commonly set (with reference to LIBOR, central bank rates, etc)? What rate of interest is unreasonably high in your jurisdiction and what are the consequences if a loan exceeds the reasonable rate?

Interest in the United States in a large commercial loan is most likely to be paid by computing the interest based or a LIBOR for periods of one, two, three, six and nine months or a year, plus the applicable spread. Interest is also frequently computed as a spread over a 'base' rate. Base rate can be the 'prime' rate that a bank charges its preferred customers. Base rate can also be a spread below the federal funds rate.

Some lenders, such as life insurance companies and regional banks, will make commercial loans on the basis of a fixed rate that is set at closing as a spread over US Treasuries.

Loans in the United States can also be denominated in different currencies and based on Euribor or other indices.

Under New York law, commercial transactions over US$2.5 million are not subject to civil or criminal usury. Each state has its own usury laws. Different states have different exceptions from usury laws.

If a loan is usurious, as a general rule it becomes unenforceable. Fees, shares in appreciation and additional interest are all calculated as part of interest when determining if a loan is usurious.

26 Default and enforcement

How are remedies against a debtor in default enforced in your jurisdiction? Is one action sufficient to realise all types of collateral? What is the time frame for foreclosure and in what circumstances can a lender bring a foreclosure proceeding? Are there restrictions on the types of legal actions that may be brought by lenders?

Enforcement methods vary from jurisdiction to jurisdiction. In New York, there is a statutory 'power of sale' as well as a statutory method of strict foreclosure. Power of sale (ie, non-judicial foreclosure) is rarely used because there is concern about whether such process is sufficient to cleanse title and title companies are reluctant to insure title obtained from such a procedure. Power of sale foreclosures do work in other jurisdictions.

Following the New York Real Property Actions and Proceedings Law to foreclose is long and tortuous. Statutory requirements for service of 'necessary parties' is strictly required. In New York, a lender may not pursue both foreclosure and enforcement of a note or guarantee at the same time. If the guarantee is not for payment in full of the loan (and with a creditworthy party), a lender will foreclose and move for a deficiency judgment, which must then be enforced against the assets of the guarantee – if the lender is able to locate such assets. Indeed, because gaining title to the mortgaged property is the surest method of repayment in most loans, nearly every lender elects to proceed first to foreclose.

In California, on the other hand, the form of security instrument is a deed of trust. The statutory process is such that a foreclosure sale can occur in 120 days. (Texas is even faster.) However, California has a 'one action' rule that requires extreme care be taken before exercise of any remedy.

A court will generally require a 'real' default in order to permit foreclosure. A 'real' default is usually a payment default rather than a breach of a non-monetary covenant or a covenant to maintain a certain debt service coverage ratio. Courts are looking for significant harm to the collateral. Courts hearing a foreclosure case are 'courts of equity' and will not be inclined to cause a borrower to lose its property for other than a payment or serious default affecting the property.

In the United States, courts look to preserve 'the equity of redemption'. Virtually every state provides that a borrower may redeem its property by paying off all amounts that are due. In a number of states, the right of redemption continues for a period post-foreclosure.

If a lender made a 'mezzanine loan' that is secured only by a security interest in the ownership interests of an entity, the lender may foreclose under the Uniform Commercial Code, which is a much faster process than the foreclosure of a mortgage or deed of trust.

27 Protection of collateral

What actions can a lender take to protect its collateral until it has possession of the property?

We recommend that lenders collect 'rents' from the property in a lockbox and cash management arrangement, pursuant to which the borrower directs its tenants to send rent cheques to a post office box, from which a designated bank will extract rent cheques and deposit the money in a collections account. The bank will then make the monthly debt service and reserves payments directly to the lender and remit the balance to the borrower. The use of rents becomes a primary concern at a point of enforcement. Rents are generally payable monthly and present a current problem in the event of enforcement proceedings; whereas deterioration of the property takes longer. Alternatively, a lender may send notices to the borrower's tenants to pay rent to the lender (assuming the perfection of the lender's liens against the property and the rents) but tenants are likely to ignore such notices and continue to pay rent to the borrower in order to avoid a default under their leases. A borrower is likely to continue to use rents to pay debt service, particularly when there is a recourse carve-back guarantee (as subsequently described).

New York has a doctrine of 'mortgagee in possession', permitting the mortgagee to take possession of and operate the property. Such possession makes the mortgagee strictly liable for everything that happens. Needless to say, this is rarely used.

A lender may move for the appointment of a receiver. If done in a timely manner, such motion may be done ex parte (ie, without notice to the borrower). A receiver will operate the property as an officer of the court. The receiver does not answer to the mortgagee. The receiver is charged with preserving and improving the property. That gives the receiver the power to request funds from the lender for tenant improvement allowances for new leases, for example. Receivers are typically expensive. In New York, a receiver for large commercial properties is entitled to a fee of 5 per cent of the gross rents. Lenders seek the appointment of a receiver in cases in which there is fraud or mismanagement or if there is no functioning lockbox arrangement in place.

28 Recourse

May security documents provide for recourse to all of the assets of the borrower? Is recourse typically limited to the collateral and does that have significance in a bankruptcy filing? Is personal recourse to guarantors limited to actions such as bankruptcy filing, sale of the mortgaged property or additional financing encumbering the mortgaged property or ownership interests in the borrower?

Loan documents vary in terms of whether recourse is to the borrowing entity or designated guarantors, or to the collateral. The distinction can have an effect in a couple of circumstances. Recourse to the collateral will not entitle a lender to funds in accounts of the borrower unless there are security interests in such accounts. The other distinction occurs if the borrower files for bankruptcy. If the lender is undersecured (ie, the property has lost value since the time the loan has closed), the lender will want to retain an unsecured claim and make an election to do so under section 1111(b) of the Bankruptcy Code, which it may do with recourse to borrower.

As a practical matter, since most borrowers are single purpose entities, a borrower should not have a problem giving recourse to its assets (which are likely to be limited to the mortgaged property).

A lender will usually provide in the loan documents that the lender limit recourse to the mortgaged property and rents. A lender will typically require certain designated principals of the borrower to be personally responsible for:

(i) environmental indemnities;
(ii) losses from fraud, misapplication of rents, insurance proceeds and condemnation awards and similar malfeasance, and the failure to maintain single purpose entity (SPE) status); and
(iii) the entire loan, if the mortgage property is sold or encumbered without the consent of the lender or the borrower attempts to frustrate the lender from exercising its remedies, or if the borrower files for bankruptcy protection.

The principals will execute an environmental indemnity agreement to cover the environmental indemnities and a non-recourse carve-out guarantee to cover the losses described in clause (ii) and the repayment of the loan in clause (iii).

29 Cash management systems

Is it typical to require a cash management system and do lenders typically take reserves?

Securitised loans always require lockbox and cash management systems to be in place. Balance sheet lenders have latitude in deciding whether to require a cash management system.

30 Credit enhancements

What other types of credit enhancements are common? What about forms of guarantee?

Credit enhancements are determined by the basis on which the lender has underwritten the loan. Construction loans generally require a guarantee of completion that would be enforced as a deficiency guarantee, in that the lender would want to recover the amount needed to complete the building (and, with some lenders, to cover the interest that accrues during construction). These completion guarantees typically cover removal of liens, payment of budget shortfalls and estimations of cost to completion. A lender may require a debt service reserve, guarantee or a letter of credit in lieu thereof. If a homeowners' association or ground lease is involved, a lender is likely to require a guarantee of payment of funds due to the association or the ground lease landlord. A lender may also require a partial or total guarantee of payment.

Virtually all lenders require a non-recourse carve-out indemnity to protect the lender against 'bad acts'. Bad acts customarily include fraud, failure to use funds from the property for paying the loan or paying taxes, keeping insurance in force, maintaining single purpose entity requirements, and so forth (see question 29).

These types of indemnities generally require that in the case of a voluntary or collusive bankruptcy, or if the property is sold or further encumbered without the consent of the lender, the loan will become fully recoursed to the guarantor.

There is also an environmental indemnity given by the borrower, and often the guarantor.

31 Loan covenants

What covenants are commonly required by the lender in loan documents? What is the difference depending on asset classes?

Covenants generally include obligations to maintain the property, pay all property taxes assessed against the property, comply with all laws, maintain the insurance required under the loan documents, comply with environmental obligations, obtain the lender's consent to leases within certain pro forma requirements, and obtain the lender's consent to a transfer of the property or ownership interests in the borrower or the addition of further mortgage debt. If the loan is a construction loan, there will be covenants to complete construction. If the loan concerns an office building or retail centre, the lender will require that borrowers comply with all obligations under leases and obtain consent of the lender to new leases or the modification or termination of existing leases. Hotel borrowers will be required to maintain the hotel management and franchise agreement in full force.

32 Financial covenants

What are typical financial covenants required by lenders?

Many single asset loans contain requirements that borrowers maintain a required debt service ratio, although this is not a requirement in many other transactions. Such compliance may be perpetual or required to exercise an extension option. Loans may also contain an obligation to comply with loan-to-value covenants. Many loans, however, do not contain such requirements, and, as noted above, failure to comply with such covenants is not likely to persuade a court to permit the lender to foreclose on the property if the borrower is up to date with the payment of debt service and the proper maintenance of the property.

If a loan is made to an operating entity (particularly a hotel) as opposed to a single purpose entity, the operating company may be subject to covenants regarding overall debt, restricted payments, debt-to-leverage ratios, fundamental changes, limits on capital expenditures, EBITDA, and so on.

33 Bankruptcy

Briefly describe the bankruptcy system in your jurisdiction.

In the United States, bankruptcy is a matter of federal law (the US federal Bankruptcy Act). It will look to state law for issues such as whether an agreement was validly terminated prior to bankruptcy.

Any party may file a voluntary proceeding by filing a petition. An involuntary petition may be filed by creditors of the bankrupt party. The filing of such petition stays enforcement of all actions (except those in the ordinary course of business). A filing by a single purpose entity is easier to deal with than that of an operating company. A lender may either attempt to have the court determine that the entity should not be in bankruptcy or request relief from the automatic stay to pursue remedies.

The secured creditor that is properly perfected will move for control over rents. If the secured creditor is not fully secured, it may not receive interest during the pendency of the case.

Even in a single asset case, there will be other creditors of the borrower. Junior creditors, such as trade suppliers, will each put in a claim. Depending on circumstances, the lender may be able to get relief from the automatic stay.

Issues come up in bankruptcies regarding the debtor's right to terminate leases and executory contracts.

Bankruptcy courts will hear matters appurtenant to the core bankruptcy case, such as priority of mechanics' liens.

A borrower may file under chapter 11 of the Bankruptcy Act in order to reorganise, or under chapter 7 of the Bankruptcy Act in order to liquidate. There are provisions for conveyances out of bankruptcies.

34 Secured assets

What are the requirements for creation and perfection of a security interest in non-real property assets? Is a 'control' agreement necessary to perfect a security interest and, if so, what is required?

The creation and perfection of liens in personal property (ie, not real property) are governed by the Uniform Commercial Code (UCC), which has been adopted in most states with only slight differences from state to state.

For most assets commonly subject to liens in loan transactions, the creation and perfection of liens is governed by article 9 of the UCC, which generally requires that there be a security agreement (which may be the mortgage in a real estate loan transaction for the purpose of granting a security interest in the items of personal property located at the real property) granting the security interest and a filing of a UCC-1 financing statement with the secretary of state of the state in which the borrower is organised in order to perfect the security interest. For certificated securities, articles 8 and 9 of the UCC provide that perfection may be achieved by either the lender having actual possession of the securities or by filing a UCC-1 (although a lender with possession has priority over a lender that only filed a UCC-1).

Under the 2006 amendment of the UCC, to perfect a security interest in a depository account, a control agreement with the depository is required.

35 Single purpose entity (SPE)

Do lenders require that each borrower be an SPE? What are the requirements to create and maintain an SPE? Is there a concept of an independent director of SPEs and, if so, what is the purpose? If the independent director is in place to prevent a bankruptcy filing, has the concept been upheld?

As a general matter in the United States today, lenders require that borrowers be single purpose entities. The reason for this is to prevent funds for one project being used for another project and to prevent the liabilities and creditors of an asset in distress from impairing another asset. Additionally the goal is to prevent the bankruptcy of one entity from causing an affiliate of such entity to be consolidated with such entity. The indicia of a single purpose entity are factual, essentially showing that such entity makes decisions and operates on its own. Most lenders require the borrower's organisational documents to contain certain covenants designed to assure that the entity will remain a single purpose entity.

Some lenders (particularly in securitisations) require that an independent director be appointed. Such independent directors must vote affirmatively for an entity to file for bankruptcy. It is unclear whether courts will enforce this, as several court cases have found that directors have a fiduciary duty to the company.

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