The Real Estate Law Review

Eighth Edition

Editor
John Nevin

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THE REAL ESTATE LAW REVIEW

EIGHTH EDITION

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For further information please contact Nick.Barette@thelawreviews.co.uk

Editor
John Nevin

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PREFACE

I am delighted to introduce the eighth edition of *The Real Estate Law Review*. The continued success of the *Review* confirms its relevance to real estate practitioners and their clients. Real estate is increasingly viewed on a global basis and readers can only benefit from a general understanding of how individual jurisdictions operate within the global real estate market.

This edition extends to 31 jurisdictions, and we are delighted to welcome new contributions from distinguished practitioners from around the world. I am very grateful to all contributors for their hard work and essential role in compiling this eighth edition. Each chapter provides an invaluable insight into key legal issues and market trends in the author's jurisdiction and, together, they offer an up-to-date synopsis of the global real estate market.

The *Review* seeks to identify distinctions in practice between the different jurisdictions by highlighting particular local issues. We believe that this offers investors and occupiers and their professional advisers an invaluable guide to real estate investment outside their own domestic market. Overseas investors are increasingly prepared to look beyond traditional markets and sectors to exploit international opportunities as and when they arise. Often, investors need to act quickly, and we hope that the *Review* provides an advantageous starting point to understanding cross-border transactions in the light of the reader's own domestic forum.

International economic and political instability continues to have a significant effect on the global real estate market. In the UK, Brexit-generated uncertainty remains as negotiations for leaving the EU are still ongoing as we approach the 29 March 2019 deadline. However, the continued attraction of UK real estate to overseas investors confirms that each event or development in a particular country must be seen in a global context to ascertain the bigger picture. It is no longer possible to ignore globalisation and view real estate markets in isolation. Brexit notwithstanding, the UK remains a safe haven for investors from around the world, and investment levels in London and the wider UK market remain buoyant.

In addition to all the distinguished authors, I would like to thank the members of the Law Review team for their tireless work in compiling this eighth edition of *The Real Estate Law Review*.

John Nevin
Slaughter and May
London
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Chapter 32

UNITED STATES

Meredith J Kane[1]

I INTRODUCTION TO THE LEGAL FRAMEWORK

The investor in US commercial real estate should be familiar with both the type of investment entity that is used for the interest in real estate being acquired by the investor, as well as the type of ownership interest that the investment entity holds in the underlying real property.

i Ownership of real estate

Investors typically hold their interests in US commercial real estate through the following investment entities: a limited liability company (LLC), a limited partnership (LP), a real estate investment trust (REIT), a tenancy in common (TIC) or direct investment. Each of these investment entities will be discussed further in Section IV.

The investment entities in turn own the underlying real property asset. The most common forms of ownership of US commercial real estate are fee simple title and ground leasehold title.

In fee simple title ownership, the ownership entity owns all right, title and interest in the real estate asset, including the right of free alienation of the asset. The fee simple estate is not limited in duration, and there is no superior titleholding estate. A fee simple estate is subject only to liens and encumbrances that are superior to the estate by reason of an express grant of priority by the fee simple owner, such as a mortgage or an easement that expressly encumbers the fee simple estate.

Where a fee simple owner wishes to convey a long-term interest in the real estate asset to a third party but wishes to retain the underlying fee title, typically for reasons of taxes or inheritance, the fee owner will commonly enter into a long-term ground lease that will enable a third party to lease, develop and operate the real estate for the lessee's account. Ground leases are usually of at least 49 years' duration, and are often 99 years or longer. Such long terms are necessary for the ground lessee to finance the development of the real estate and to amortise its equity investment in development of the real estate. A ground lease is a fully net lease, where the lessee develops, finances, operates, maintains and insures the property for its own account. Financing for the acquisition and development of the leasehold interest is secured solely by the lessee's interest in the ground lease, and not by the fee interest itself, which remains superior to the lease and the financing. From the standpoint of the safety of a real estate investment, a ground landlord's position under a ground lease, where the lessee has invested in improving the real estate, is among the most secure investments available.

1 Meredith J Kane is a partner and co-chair of the real estate department at Paul, Weiss, Rifkind, Wharton & Garrison LLP.

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ii System of registration

The system of registration of real estate titles is governed by the laws of each state. The land title registries for each state are administered by local governments – city, town or county – which are subsidiary governmental jurisdictions in each state. Title registration occurs through the recording of deeds, easements, mortgages and other encumbrances in the local registry offices when a transaction is closed. Recording of title documents is necessary to establish priority and right in estate over other competing interests in the same property. It is customary for a buyer or a lender in US real estate transactions to engage a title insurance company at the time of entering into a contract to purchase property to examine the local title registries to determine the ownership of real estate and any encumbrances of record, and to engage a surveyor to determine land boundaries and locations of improvements and easements. At the closing of title transactions, it is customary to purchase title insurance to ensure that good title is being acquired by the purchaser, subject only to identified encumbrances. Title insurance is also required by most mortgage lenders, to ensure that the lender's mortgage is a first priority lien on the real estate. The premiums for title insurance vary by state, as do specific endorsements that title insurers are permitted to underwrite. Many state and local governments impose transfer and recording taxes and fees on the transfer or recording of real property titles, based on the dollar value of the consideration paid for the real estate being transferred. Transfer taxes can range from a few tenths of a percentage point to more than 3 per cent.

iii Choice of law

The laws of each state govern the legal frameworks of both the investment entities and the ownership estates in real property. There is no federal law of real estate applicable uniformly throughout the US to investment entities or forms of ownership in land, other than the commonality of federal income tax law, which helps shape the investment entities used. There is, however, a relatively high degree of uniformity in the state laws governing investment entities, as both limited partnerships and limited liability companies are governed by uniform acts written by uniform law commissions, which have been adopted with little variation as the laws of each state.

Choice of law in real estate transactions can vary based on the transaction document in question. Ownership entities will usually be established either under Delaware law (which has become the standard for sophisticated financing transactions, including securitised financing) or the law of the state in which the real estate is located. One advantage to forming an entity under the law of the state where the real estate is located is that a Delaware entity will also need to register to do business in the state in which the real estate is located.

Choice of law for deeds and title transfers is always that of the state where the real property is located. For financing transactions, it is common for there to be a split in governing law. Notes and loan agreements are often governed by New York law, which has become a standard commercial jurisdiction for lenders, while security documents, such as mortgages and UCC (Uniform Commercial Code) financing statements, are always governed by the law of the state in which the real estate is located. It is important in mortgage transactions for the lender and borrower to retain local counsel in all states where the mortgaged property is located to ensure that the mortgage documents meet state law requirements and are in proper format to be recorded in the local title registries and enforced under state law.

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II OVERVIEW OF REAL ESTATE ACTIVITY

The US real estate market continued its strong overall performance during 2018. Despite concerns that the boom market, which has been rising in value and transaction volume since 2011, may finally have topped out, both pricing and activity remained strong, despite growing softness in certain sectors, such as high-end condominiums and homebuilding. Without doubt, the key factor in the strength of the real estate market was the continued vigour of the underlying US economy overall. Job growth increased in multiple sectors, including technology, manufacturing, business services and warehousing, bringing with it a continued demand for office space, logistics space, and for multifamily residential space. Other additional key factors keeping prices and transaction activity strong in US real estate in 2018 included continuing moderate increases in interest rates from the Federal Reserve that were easily priced into the market expectations, continued strong capital availability from pension funds and other institutional investors seeking strong returns, and the stability of the US markets that continue to provide a stable, safe haven for overseas investors' funds. The emerging consensus among real estate investors is that, unlike in past cycles, the real estate market trajectory will be in for a 'soft landing', rather than a hard downturn.[2] Commentators expect that 2019 will be the year in which the US will experience a slowdown of transaction volume as well as a 'plateau' in asset pricing.[3]

The retail sector continues to transform as e-commerce puts increasing pressure on bricks-and-mortar retail. Both urban street-level retail and shopping centre retail have suffered major vacancies, because of a large number of retailer bankruptcies and a reduction in store count by national retailers. To survive the challenge of online competitors, big-box stores, department stores and grocery retailers have increased their own emphasis on e-commerce initiatives and delivery systems. Retail store spaces and shopping centres have increasingly focused on reconfiguring their spaces into 'experience' centres focusing on food, entertainment and personal services, as well as other 'common space' uses. Showrooms in which customers can try on, in real life, products that they have purchased through e-commerce are also becoming a common use. Short-term 'pop-up' stores, on leases of one year of less, allow retailers to test retail concepts without making a heavy investment in space.

The office sector also continues to transform, as start-up tech companies become more dominant space users, and older tech companies become more mature office users. The biggest phenomenon in office space leasing has been the rise of short-term, flexible office space offered on a weekly or monthly basis, with access to common services and common 'business interaction' spaces, through firms like WeWork and multiple competitors. Amazon, one of the tech sector's largest companies, created a nationwide competition to site Amazon's 'HQ2', with its promise of 50,000 well-paid tech sector jobs, in which nearly 250 cities, states and towns from across the US competed. Ultimately, Amazon selected Long Island City, in New York City, and a suburb of Washington DC, as the two winning sites, exacerbating the 'tech divide' between the booming coastal cities and the slower-growth areas of the US.

In terms of capital sources for real estate markets, CMBS issuances declined from US$95 billion in 2017 to US$76.4 billion in 2018. The decline is attributed to increased competition from private equity sources, as well as an overall decrease in the amount of

2 Source: PriceWaterhouseCoopers, 'Emerging Trends in Real Estate 2019 Survey'.
3 Source: Urban Land Institute (ULI), 'Emerging Trends in Real Estate 2019'.

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maturing CMBS debt needed to be refinanced, which hit its peak in 2016–2017.[4] Other matters affecting the CMBS market include market volatility causing spreads to fluctuate, with capital availability drying up at times of tightening spreads, as well as to the effects of the 'risk-retention rule', which was put into effect during 2016 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[5] The 'risk-retention rule' rule requires that issuers retain a minimum of 5 per cent of the risk in their CMBS issuances, either as a 'vertical slice' across all tranches, or a horizontal slice at the lowest tranche, or an 'L-shaped slice', combining vertical and horizontal interests. CMBS delinquency rates reached a new post-2008 low of 3.11 per cent by December 2018. Retail delinquency rates continued to be the highest of any property sector, at 5.21 per cent, with lodging and multifamily posting the lowest delinquency rates at 1.51 per cent and 1.98 per cent, respectively.[6]

Banks continue to provide the bulk of debt capital to the real estate markets (including local, regional and national banks, as well as foreign-headquartered banks), followed by life insurance companies, GSEs (for multifamily assets), and non-bank sources, including pension funds, real estate funds and real estate investment trusts (REITs).[7]

Equity activity in real estate continued strong in 2018 as investors sought yield and equity was in demand to cover gaps in the capitalisation structure brought about by reduced loan to value ratios. Annualised private real estate fund returns in the three years ended June 2017 were approximately 15 per cent, showing consistent performance over several years. Capital raising for private real estate funds surpassed US$100 billion annually for the last five years. Total closed-end private real estate assets under management exceeded US$800 billion in June 2017, with US$150 billion in 'dry powder' available for investment in US real estate. The high pricing of assets, fuelled in large part by the massive pools of capital seeking returns in real estate, are the major concern expressed by private investors, along with anticipated effects of interest rate increases.[8] Private real estate equity funds include institutional equity from asset managers, insurance companies, pension funds, foundations and endowments, which in recent years have increased their exposure to real estate to increase yield. Institutional investors are still largely focused on 'core' properties with stable yields, but 'value-add' properties and secondary and tertiary markets, with the greatest potential for value increases, are included in institutional portfolios as strong competition for core properties has driven prices to extremely high levels.

Office leasing activity throughout New York City increased in 2018 to its highest level in nearly 20 years, with over 32 million square feet of space leased in Manhattan alone.[9] Large corporate users inked lease deals at major new office space at Hudson Yards as well as new and renovated spaces in East Midtown and Downtown Manhattan, Long Island City and Downtown Brooklyn, which have come on line after several years of development. Financial services firms remain the largest space users by sector. Fast-growing tech companies, led by Amazon's new HQ2 in Long Island City and Google's expansion in lower Manhattan, accounted for nearly a quarter of the newly leased space. Co-working firms also increased

4 Sources: National Real Estate Investor, 'Stuck in Neutral: CMBS Issuance Stalls Amid Stiff Competition', 24 October 2018; KBRA CMBS Trend Watch, December 2018.
5 Source: USAA Real Estate Company, 'What Happened to CMBS Issuance in 2016?', February 2017.
6 Source: Trepp CMBS Research, December 2018.
7 Source: National Real Estate Investor, 'Maintaining Liquidity', 1 October 2018.
8 Source: Source: Preqin Fund Manager Outlook 2018.
9 Source: CBRE Manhattan Office Market Report Q4 2018.

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their spaces under lease, taking nearly 20 per cent of leasing volume. Downtown Manhattan, with its relatively affordable office space, solidified its role as the new hub of the media and advertising industry in New York City. Affordable housing, particularly multi-family rental housing, remains a challenge that must be solved to sustain job growth in New York City and other high-cost urban areas.

III FOREIGN INVESTMENT

The US commercial real estate markets remain an attractive investment target for foreign capital seeking a stable political environment and stable currency. Commercial real estate remains a relatively attractively priced asset, with the potential to generate substantial operating income and capital gains as markets continue to expand. For the first half of 2017 (the latest period for which statistics are available), direct foreign investment in commercial real estate totalled US$19.8 billion, a slight decrease from 2016's pace, which totalled US$55.1 billion for the year. The major source of foreign capital remains Canadian pension funds, which accounted for 30 per cent of year-to-date foreign investor activity. Asian capital investment continues strong, with almost half of the offshore acquisitions in 2017 originating in Asian countries. Office space continues to be the asset of choice for foreign investors, with a focus on high-quality assets in primary office markets. China, Singapore and Japan, together with Canada and Germany, accounted for nearly 80 per cent of foreign investment in the US office space sector.[10] In a change from prior years, however, there was a marked diversification of asset classes and location choices for foreign investors. Multifamily assets were the second strongest commercial asset class after office, and were located across markets.[11] Following a trend that domestic investors also initiated this year, given the high pricing of real estate assets in primary markets, a full 42 per cent of foreign investment was deployed to purchase assets in secondary and tertiary US markets.

Foreign investment in luxury US residential real estate remained strong in 2017. For the year ended the first quarter of 2017, foreign homebuyers invested US$153 billion into US residential real estate, up 49 per cent from the previous year. Chinese buyers were the most active, with purchases of US$31.7 billion during this period, with Canadian buyers in second place with US$19.1 billion. Foreign buyers now account for 10 per cent of existing home sales within the United States. Florida, California and Texas were the top destinations for foreign home buyers.[12] Notable were the declines in all-cash purchases, as well as the decline in purchases of ultra-luxury condominiums in New York City. Only 10 per cent of foreign buyers paid more than US$1 million for their residential property.

However, there are headwinds that are expected to reduce foreign direct investment in real estate in 2018 and 2019. Among other things, the low price of oil throughout 2018, with its effects on the Russian and Middle Eastern economies, the slowdown in the growth and imposition of capital export restrictions of the Chinese economy, and the trade policies and tariffs instituted by the US government significantly slowed down ultra-luxury US residential purchases by foreign buyers. Additionally, a programme instituted by the federal government

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10 Source: JLL – the Investor Q3 2017.

11 Source: Newmark Knight Frank, 'Foreign Investment in US Commercial Real Estate', December 2017.

12 Source: Inman Connect 7/2017, citing National Association of Realtors 2017 Profile of International Activity in US Residential Real Estate.

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in cooperation with New York City, requires disclosure of individual owners behind all-cash luxury apartment purchases and has led to a continued decline in all-cash transactions, typical of ultra-wealthy foreign buyers.

i Foreign Investment in Real Property Tax Act

Foreign investment in US commercial real estate is generally done through a US-taxpaying entity, to avoid the 15 per cent withholding tax provisions of Internal Revenue Code Section 1445(a), implementing the provisions of IRC Section 897, the Foreign Investment in Real Property Tax Act (FIRPTA). The most commonly used US-taxpaying entity for foreign investment is a US corporation that is a wholly owned subsidiary of the foreign investor. As with LLCs and LPs, corporations are also organised under state law, usually either Delaware or the state in which the real estate is located. The foreign investor is thus subject to the US income tax with respect to the ownership and operations of US real estate, including capital gains taxes on dispositions. At the end of 2015, long-sought amendments to FIRPTA were enacted into law, expanding exemptions from US taxes for foreign pension funds that invest in US REITs or directly in real estate, thus putting foreign pension funds on similar tax footing to US-based pension funds. This change is intended to, and expected to, increase foreign pension fund investment in US real estate.

Loan activity by a foreign lender to an unrelated US borrower, where the lender is domiciled outside of the US, and where the loan is sourced and negotiated outside the US, is not subject to US withholding tax.

ii EB-5 Immigration Program for Investment in Job Creation

An incentive for foreign investment that has become increasingly widespread in use over the past five years is the 'EB-5' programme, under which a foreign national becomes entitled to receive an employment-based fifth preference (EB-5) immigrant visa in return for investing in a new commercial enterprise within a US government-designated regional centre. The required investment is US$1 million of foreign capital, which is reduced to US$500,000 for an investment in an area of high unemployment or in a rural area. The investment must create at least 10 full-time US jobs. The EB-5 investment is structured either as a preferred equity investment with a fixed return, or as secured debt. EB-5 investment has become a primary source of low-cost investment capital for real estate development projects, where jobs are generated through construction activity as well as business occupancies. China is the main source of EB-5 investment dollars for US real estate transactions, exceeding 70 per cent of the EB-5 applications over the last three years. The EB-5 programme was recently extended through 15 February 2019, largely as a result of strong lobbying by the real estate industry. Its future after that point is uncertain.

IV STRUCTURING THE INVESTMENT

Real estate ownership is typically structured so that an entity with limited liability is the owner of the direct fee title or ground leasehold interest in the real estate. The investors hold interests in these entities, rather than directly owning the title to the real estate. The most common types of limited liability entities that own real estate assets are the LLC, the LP and the REIT.

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LLCs and LPs are organised under state laws, most commonly either Delaware law or the laws of state in which the real estate is located. An LLC is managed by a manager or a managing member, and an LP is managed by a general partner. The investors are typically non-managing members or limited partners in the property-owning entities.

A major advantage of an LLC or LP structure is that an investor is not liable for the debts or liabilities of the title-holding entity beyond the funds invested in the entity. Thus, an investor is insulated from property liabilities through this investment structure, including property-level debt. A second major advantage is that both LLCs and LPs are 'pass-through' entities for federal income tax purposes, meaning that all income and losses of the entity are passed through to the members and taxed solely to the members, with no second level of tax at the entity level. Investors can use income and losses of the property to offset income and losses of other real estate investments for tax purposes, and tax-exempt investors can enjoy fully tax-exempt income. The recently adopted US federal income tax overhaul further advantage the use of pass-through structures by providing for a 20 per cent deduction for all income earned through pass-through entities, before the individual tax rate is applied.

Typical provisions of the LP or LLC agreement describe:

a the capital contributions of the parties, obligations, if any, of the parties to contribute additional capital to the entity, and rights and remedies if a party fails to make required future contributions;

b the decision-making process of the entity, including major decisions that will require approval of all or a majority of the investors;

c the timing and priority of distributions of available cash and capital proceeds to the parties, including preferred returns and carried or promoted interests;

d allocations of income, gain and loss for tax purposes; and

e exit rights of the parties, including buy-sell rights, forced-sale rights, and provisions governing sales of interests and rights of first offer or refusal.

Another relatively common structure for ownership of real estate is the REIT. This structure, defined by Section 856 of the Internal Revenue Code, is used to hold interests in real estate where maximum liquidity is desired. The REIT is organised as a corporation with shareholders, in which the shares may be publicly or privately traded. To enjoy a 'pass-through' tax treatment similar to LLCs and LPs, including the new 20 per cent deduction from taxable income, a REIT is required to meet prescribed IRS requirements, including that it distribute 95 per cent of its taxable income annually, that it invest at least 75 per cent of the value of its total assets in real estate or real estate mortgages, and that it derive at least 75 per cent of its gross income from real property rents, interest, proceeds of sale and similar. Most REITs traded on the US markets today are large corporations with multiple property holdings, usually in a single asset class (residential or office), but often in multiple geographic markets to provide asset diversification to REIT investors.

In addition to their advantages as pass-through tax entities, REITs enjoy an advantage in the marketplace for acquisitions because of their ability to finance acquisitions relatively inexpensively. Although REITs are not permitted to retain earnings, REIT property acquisitions are financed with corporate lines of credit, which provide a relatively less expensive source of financing than property-level debt, or by issuance of new stock.

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V REAL ESTATE OWNERSHIP

i Planning

Planning and land use issues are largely controlled by states and municipalities, through the mechanism of zoning laws adopted by local jurisdictions. In rural and suburban areas, zoning laws focus on master plans for large-scale developments and related infrastructure, with a focus on controlling density, preserving open space and ensuring that there is adequate water, sewer capacity and other necessary utilities for developments. Preservation of wetlands and natural habitats of endangered plant and animal species are controlled by federal laws, in addition to local zoning laws. In urban areas, zoning laws will prescribe, for each specified zoning district, the uses to which real estate can be put (industrial, commercial, residential or institutional), the density of development (number of square feet of building space per unit of land area), the height, setback and overall architectural configuration of individual buildings, the sizes and configurations of yards and open space, and street frontages. Zoning laws often contain incentives or requirements for developers to provide public goods, such as affordable housing, parks and other public amenities in connection with a new development. Many localities also require preservation of designated landmark buildings. Legal challenges to land use regulations continue to be brought in state and federal courts, which set the limits of how far government can go in regulating the uses to which land can be put without constituting an unconstitutional 'taking' of the private property of the landowner.

ii Environment

Liability of a landowner for contamination of land and water by hazardous substances is governed by both federal and state laws, and enforced concurrently by federal and state governments. The primary federal laws governing hazardous substances liability are the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and Resource Conservation and Recovery Act (RCRA). Both of these statutes make the owner and the operator of land financially and legally responsible for hazardous substance contamination of land that they own or operate, as well as any contamination of neighbouring land or water caused by activities on the land they own or operate. Nearly every state has adopted environmental statutes requiring owners and operators to prepare specific plans for approval by the state environmental agencies for remediation of soil and water contamination caused by hazardous substances. Some states require an approved remediation plan to be in place before an owner can transfer title to any property that was used for industrial use. As part of the due diligence investigation for a property acquisition, a buyer will conduct a Phase I environmental study to determine the past uses of the land, and whether any federal or state environmental violations have been noted. If the Phase I study indicates possible environmental liability, a Phase II study, in which soil and groundwater samples are studied, is customarily undertaken prior to property acquisition. A new buyer of property will become liable for clean-up obligations, even if they have occurred in the past, although the new owner will have the right to claim against the prior owner or operator that caused the contamination. Several insurance products are currently available to property owners to protect against unknown liabilities for prior pollution, and are becoming the norm in transactions for sophisticated buyers.

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iii Tax

Many state and local jurisdictions, including towns or counties, impose a transfer tax on transfers of real estate. The amount of tax generally ranges from a few tenths of a percentage point to more than 3 per cent of the consideration paid for the transfer. Nearly all jurisdictions that impose a transfer tax will tax transfers of fee title. Others will also tax long-term ground leases, transfers of majority interests in entities that own real estate, and transfers of other title interests, including easements, lease assignments, and air rights. Some jurisdictions will also tax mortgages based on a percentage of the principal amount. These taxes are paid at the time of transfer and recording of the transfer instrument, and are usually (but not always) imposed on the transferor.

iv Finance and security

The most common forms of security for a real estate loan are a mortgage (which creates a security interest for the lender in the real estate) and a mezzanine pledge (which creates a security interest for a lender in the ownership interests in the entity that owns the real estate). A first-priority mortgage is given to the most senior lender, typically with a loan that does not exceed 50 to 75 per cent of the value of the property. If larger amounts are borrowed, the additional loan will be junior in priority to the mortgage loan, and will be secured by a pledge of the ownership interests in the entity that owns the real estate, and not the real estate itself. Thus, when a first mortgage lender forecloses on a mortgage collateral to enforce its loan, it will ultimately hold a sale of title to the property itself to receive repayment on its loan, and will wipe out all junior liens, including a mezzanine pledge, in the event that the sale proceeds are not sufficient to pay off claims. When the mezzanine lender forecloses on its security interest in the ownership entity, it will take title to the ownership interests of the property subject to the mortgage, and the mortgage will remain intact. Both mortgages and security pledges are subject to and enforced under state laws. While details of the enforcement process vary from state to state, lien priority issues are generally similar. In CMBS, where mortgage loans are pooled into a single trust and securities of differing priorities created in the trust, the enforcement of the underlying mortgages follows the same state law process as for single loans.

VI LEASES OF BUSINESS PREMISES

Most occupancy by businesses of retail and office space is done through leasing rather than ownership by the business of the space it occupies. The leasing arrangement allows businesses to have maximum flexibility to expand and acquire more space or relocate geographically as needed, and not to tie up scarce capital in real estate.

i Office leases

Typical provisions of office leases are as follows.

Term and renewals

Terms are usually 10 to 15 years, often with options to renew for one or two additional five-year periods.

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Base rents and operating expenses

Base rents are either fully net, where the tenant pays a base rent plus its *pro rata* share of all operating expenses and real estate taxes attributable to the property, or pays a base rent plus its *pro rata* share of increases in operating expenses and real estate taxes over a stipulated base amount. Base rents will increase on an annual basis, or will increase cumulatively over a five-year period, at a stipulated amount sized to keep pace with anticipated inflation.

Tenant improvements

An office landlord will pay for initial improvements to the office space, or provide an allowance to the tenant to pay for improvements, and will provide a period of free rent at the beginning of the lease to enable a tenant to complete the work and move in. The cost of these concessions is factored into the rent.

Assignment and subletting

Tenants may be permitted to sublet with landlord approval, with criteria as to creditworthiness of the successor, and non-competition with landlord's leasing of the building. The tenant will usually be required to give or share any sublease profits with landlord. Tenants are not relieved from lease liability by assigning or subletting, but remain jointly and severally liable with the subtenant.

Building services

Tenants will often be required to purchase building services, such as electricity, cleaning, air conditioning and building management, through the landlord.

Default and termination

If a tenant defaults in lease performance, a landlord may terminate the lease and evict the tenant by court order from possession of the premises. Even after a lease is terminated and the tenant evicted, the tenant will remain liable for damages equal to the rent under the lease until the landlord finds a replacement tenant (and will thereafter remain liable to pay any shortfall between the lease rent and the new rent).

ii Retail leases

Retail leases differ from office leases in the following respects:

Terms and renewals

In today's volatile retail market, a new trend is the short-term (one year or less) 'pop-up' retail lease, with longer extensions after the initial try-out period.

Base rent

Base rent is usually fully triple-net, and tenants are responsible to pay a *pro rata* share of property operating expenses and real estate taxes from dollar one, rather than over a stipulated base amount.

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Percentage rent

Retail rents commonly include 'percentage rents', in which tenants pay, in addition to base rent and operating expenses and taxes, a percentage of their adjusted gross sales proceeds over a breakpoint. This enables a landlord to offer a lower going-in base rent, and to share in the upside if sales are robust.

Common area maintenance charges

In shopping malls and other retail centres where there are large common areas, and tenants benefit from common marketing and promotional activities, there is also a CAM, or common area maintenance charge, paid *pro rata* by tenants.

Use clauses and continuous operation covenants

Retail leases, particularly in shopping centres, generally contain strict use clauses identifying the image, branding and products to be carried by the retailer, as well as minimum and maximum hours of operation and a covenant to operate without interruption. Both landlord and tenant will expect radius restrictions on competing operations – the tenant will be restricted from having another identical brand store within a specified radius from the shopping centre, and the landlord will be restricted from having competing brands within the shopping centre, to help ensure the success of the retail operations.

VII DEVELOPMENTS IN PRACTICE

Following are some of the major recent developments in US real property law and practice.

i Opportunity Zone investments

The Opportunity Zone incentive is a new community investment tool established by Congress in the Tax Cuts and Jobs Act of 2017 to encourage long-term investments in low-income urban and rural communities around the US by providing tax benefits to investors. First, investors can defer tax on any prior gains invested in a Qualified Opportunity Fund (QOF) until the earlier of the date on which the investment in a QOF is sold or exchanged, or 31 December 2026. If the QOF investment is held for longer than five years, there is a 10 per cent exclusion of the deferred gain. If held for more than seven years, there is a 15 per cent exclusion of the deferred gain. Second, if the investor holds the investment in the Opportunity Fund for at least 10 years, the investor is eligible for an increase in basis of the QOF investment equal to its fair market value on the date that the QOF investment is sold or exchanged, thereby avoiding capital gains tax altogether.

ii CMBS loan originations and securitisation

There is an ongoing rethinking of all aspects of lending practices in the CMBS market, in response to the default and workout experiences in the post-2008 crisis years. On the loan underwriting side, improved protections of 'CMBS 2.0' include higher debt-service coverage ratios, lower loan-to-value ratios, and more conservative cap rate analysis and property valuations. On the securitisation side, protections include higher credit enhancement requirements, deeper junior tranches to support 'super-senior' tranches, and enhanced regulatory requirements, including the 5 per cent issuer risk retention described above, which was first put into place in 2016. On the legal or structural side, protections include the use

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of an 'operating adviser' to represent the interests of all bondholders while a loan is in special servicing, transfer of the 'controlling class' rights based on appraisal rather than realised reductions in portfolio value to better align decision-making with the first-loss position, and a move towards uniform representations and warranties.[13] There has also been increasing focus on conflicts of interests between special servicers on CMBS portfolios and the bondholders whom they represent, in CMBS workout situations.

iii Bankruptcies

The standard in commercial mortgage financing is to establish single-purpose entity (SPE) borrowers that owned only the mortgaged asset, and will not be consolidated with other entities in the event of insolvency. In the case of a loan default, the borrower entities were discouraged from filing for bankruptcy through use of springing recourse guarantees and various SPE provisions, including independent directors. Despite these anti-bankruptcy provisions, a number of multi-asset real estate companies have over the past few years sought bankruptcy reorganisation for the company as a whole, and filed their SPE asset-holding borrowers in bankruptcy as well. Some notable legal principles to emerge from recent high-profile real estate bankruptcies are that:

a SPE borrowers that are part of an integrated operating group of companies may consider the interests of the entire group in determining to file for bankruptcy, and need not themselves be insolvent at the time of filing;[14] and

b it does not constitute bad faith for an SPE entity to replace its independent directors installed for the purpose of discouraging a filing, and replacing them with new directors willing to file if in the best interests of the operating group.[15]

iv Enforcement of non-recourse carve-out guaranties

One of the most effective means for lenders to prevent a borrower for filing bankruptcy is to require a principal of the borrower to give a 'bankruptcy springing recourse guaranty' as part of the loan, under which the guarantor assumes full personal liability for the entire amount of an otherwise non-recourse debt if the borrower voluntarily files for bankruptcy, or colludes in an involuntary bankruptcy filing. Ratings agencies in CMBS loan securitisations put strong weight on the creditworthiness of the guarantor standing behind these non-recourse carve-out guaranties.[16] In several decisions across the US in recent years, courts have upheld the validity of bankruptcy springing recourse guaranties against the guarantors, holding that they:

a are not void as *ipso facto* clauses under the bankruptcy code, but are rather a legitimate and permissible mode of bankruptcy-remote structuring;[17]

13 Source: Fitch Ratings, Structured Finance, 'CMBS 1.0… 2.0… 3.0 …But Are We Progressing?', 4 January 2012.

14 *In re General Growth Properties, Inc., et al.* (Bankr. S.D.N.Y., Case No. 09-11977).

15 ibid.

16 Moody's Investor Service 'Key Pillars of Loan Structural Quality are Eroding', Daniel Rubock, January 2018.

17 See *First Nationwide Bank v. Brookhaven Realty Assoc.*, 223 A.D. 2d 618 (NY App. Div. 2d Dept. 1996), finding that a bankruptcy full recourse guaranty was enforceable as written, even if no damages as result thereof; *Bank of America, NA v. Lightstone Holdings LLC and Lichtenstein Bank*, No. 09-01353 (SDNY 2009), finding that it is legitimate to carry out bankruptcy-remote structuring.

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b are not void as *in terrorem* clauses, but create an important deterrent effect to the behaviour sanctioned;

c do not constitute a penalty, or unenforceable liquidated damages, but represent an agreement to pay a valid debt of a sum certain;[18]

d do not induce breach of fiduciary duty or set up a conflict of interest for directors, whose duties are to the company and its shareholders and creditors, and not to the guarantor;[19] and

e are not void on public policy grounds favouring bankruptcy, because the real estate financial markets, consisting of powerful and sophisticated business interests, created another paradigm for dealing with lending risk and remedies that was designed to avoid bankruptcy courts.[20]

v Mezzanine lender enforcement of remedies and intercreditor agreements

Mezzanine loans, which are structurally junior debt to first mortgage loans and have as collateral a pledge of the ownership interests in the entity that owns real estate, are governed in part by intercreditor agreements with mortgage lenders entered into at the time of the financing of the property. Under a typical intercreditor agreement, a mezzanine lender is permitted to foreclose its collateral in the event of a mezzanine loan default, and following foreclosure to 'step into the shoes' of the borrower under the mortgage loan, without triggering a mortgage default. Once the mezzanine lender takes over the interests in the borrower entity, the mezzanine lender becomes liable to cure any defaults that were outstanding under the mortgage loan as of the foreclosure, to the extent susceptible of cure by the mezzanine lender. In at least two important recent decisions, state courts in New York and Arizona have refused to let mezzanine lenders foreclose their collateral unless all pre-existing mortgage defaults were cured prior to the mezzanine foreclosure, rather than following.[21] The effect of these decisions is to place significant obstacles in the path of the mezzanine lender attempting to foreclose its collateral, and to give the first mortgage lender significant leverage in workout negotiations.

18 See *CSFB 2001-CP-4 Princeton Park Corporate Center LLC v. SB Rental I LLC*, 410 N.J. Super. 114 (NJ Super. 2009), upholding full guarantor recourse (in a non-bankruptcy carve-out situation) on the grounds that repayment of debt is actual damages, not liquidated damages, and carve-out just set terms of liability rather than setting measure of damages.

19 See *UBS v. Garrison Special Opportunities Fund* (Sup. Ct. NY County, Index No. 652412/2010), finding that there is 'no distinction between this set of facts and those involving any parent corporate guaranty of a debt of a subsidiary', and that such guaranties are a 'common commercial arrangement not subject to question'.

20 See *FDIC v. Prince George Corp*, 58 F.3d 1041 (4th Cir. 1995), finding that a carve-out guaranty did not prevent borrower from filing, but guarantor would merely forfeit its exemption from liability for any deficiency.

21 *Bank of America, NA v. PSW NYC LLC*, 918 N.Y.S.2d 396 (2010) (enjoining the mezzanine lender from foreclosing on its equity interest in the mortgage borrower until after such lender cured all defaults under the senior loan, which included paying the accelerated balance of the loan totalling near US$3 billion); *US Bank Nat'l Assoc v. RFC CDO* 2006-1, Ltd, Case No. 4:11-cv-664, Doc. No. 41 (D. Ariz. 6 December 2011) (enjoining the mezzanine lender from foreclosing on its equity interest in the mortgage borrower after the mezzanine lender failed to cure all defaults under the senior loan).

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vi Distressed debt acquisition as an investment opportunity

Investors looking to acquire real estate assets at a bargain price have increasingly turned to purchases of distressed debt as a means to accomplish this. Bank lenders who hold distressed debt often find it advantageous for regulatory purposes to sell distressed debt at a discount rather than to retain the debt and reserve against it. Borrowers likewise have sometimes found new owners of the debt more able and willing to renegotiate a workout, as the new owners, having acquired the debt at a discount, are in a position to profit from a workout. Buyers of distressed debt must do substantial due diligence about the underlying real property asset and its value, the structural position of the debt (mortgage or mezzanine, or CMBS security), the type of security for the debt and any perfection problems in the security. Purchasers must also be knowledgeable about legal issues in debt enforcement that will affect the dynamics of the workout negotiations among the lender, any senior or junior lenders, and the borrower, such as the mezzanine foreclosure issues described above.

vii Land use planning and climate change: 'resilient' planning and building

Climate change is altering land use patterns throughout the US. The severe hurricanes and flooding in Houston and Florida, the lethal wildfires throughout California and the western US, and the rising sea levels across the heavily developed East Coast and Gulf Coast areas have led to a major reconsiderations of land-use patterns, waterfront development, development in flood- and fire-prone areas and building design and codes to enhance 'resiliency' in the face of long-term climate change. Flood disasters are severely constraining the liquidity of the US government's National Flood Insurance Program, which is critical to obtaining financing for real estate acquisition and construction in flood zones. Proposed changes to the programme include expanding flood zones to keep up with the reality of expanded flood risks through climate change, increasing rates to adjust for actual risk and loss experience, and require flood-resilient planning and building activities from local authorities and property owners. Wildfire losses, which are insured by private market insurers, have led to record losses, estimated in excess of US$14 billion, in 2018. The State of California, which accounted for the bulk of wildfire losses, is considering new regulations to diminish fire risk regarding construction in urban/rural interface areas, new building codes, utility operating standards, and insurance company rate adjustments. In response to rising sea levels, New York City, among others, is implementing new technologies to prevent long-term damage to both public and building infrastructure from increasingly severe storm patterns, along with zoning and building code changes. On the building level, resiliency improvements include installation of back-up generators and flood gates, raising the location of building equipment, and creating flood reservoirs in basements. On the public infrastructure level, resiliency reforms include retooling and waterproofing the electrical, transportation and communications grids, and rethinking waterfront zoning and development patterns.

VIII OUTLOOK AND CONCLUSIONS

Although it is late in the economic cycle, the outlook for the US real estate market in 2019 remains strong; however, the expectation is for flattened growth and greater stabilisation in values. Strong job growth continues to drive demand for office, retail and industrial space. Single-family homebuilding and homebuying have dropped from prior levels, but multi-family development continues strong, including workforce and affordable housing. The 'gateway city' core central business districts – New York City, Los Angeles, San Francisco,

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Austin, Seattle and Washington, DC – will continue to see increases in values and strong transaction volume as jobs, especially in the tech sector, continue to concentrate in these areas. Growth potential also continues to be strong in secondary and tertiary markets where values are lower and value growth potential is greater. Residential markets in these core areas, both multifamily rentals and condominiums, continue to show strong transaction volumes and pricing.

The top US 'markets to watch' in 2019 include Dallas/Fort Worth, TX; Brooklyn, NY; Orlando, FL; Raleigh/Durham, NC; and Nashville, TN.[22] Rents, asset values and transaction volume have increased strongly this year in these secondary and tertiary markets as the US economy has performed well overall and jobs have increased, including in the manufacturing and logistics sectors. The US housing market overall has stabilised tremendously compared with earlier years, as the overhang of foreclosed properties that depressed prices and sales volumes has eased through a lessened volume of new foreclosures and acquisitions by private equity funds of large quantities of single-family homes for rental occupancy.

The Tax Cuts and Jobs Act of 2017 is expected to push more investment into commercial real estate through especially favourable tax treatment under the law, including investments in Opportunity Zones, the deduction on pass-through income, greater deductibility of interest expense, and immediate expensing of qualified personal property. However, individual investments into homeownership are expected to decline as the bill severely caps deductibility of home mortgage interest and real property taxes payable by an individual homeowner. Additionally, there is concern that states with high real estate and income taxes may lose high-income population to lower-tax states, with a concomitant effect on real estate prices, as the tax bill eliminated the deductibility of state and local taxes.

The overall outlook for 2019 is for continued equity investment in core office and multi-family assets across primary, secondary and tertiary markets by both domestic and foreign investors. The pace and value of growth and new real estate development, however, are directly dependent on the status of the overall US and global economies, including the flows of international capital, the relative returns available in other investment sectors, and the changes in the form of demand generated by the new tax law.

22 Source: Urban Land Institute, '2019 Real Estate Trends'.

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ABOUT THE AUTHORS

MEREDITH J KANE

Paul, Weiss, Rifkind, Wharton & Garrison LLP

Co-chair of the real estate department at Paul, Weiss, Rifkind, Wharton & Garrison LLP and a former member of the firm's management committee, Meredith Kane's experience includes all aspects of development, finance, acquisitions and sales, equity joint ventures, restructuring, leasing and securitisation of real estate. Ms Kane has represented a long list of public entities and private companies in major real estate transactions in New York.

Ms Kane was Commissioner of the New York City Landmarks Preservation Commission from 1995 to 2004. She is currently Chair of the Board of Trustees of The Olana Partnership, and serves on the boards of the Lower Manhattan Cultural Council, the Urban Design Forum, the New York Foundation for Senior Citizens, the Association to Benefit Children, the Brooklyn Navy Yard Development Corporation, and the Avenue of the Americas Association (which she chaired from 1999 to 2007). Ms Kane is a member of the Board of Governors of the Real Estate Board of New York, WX-Women Executives in Real Estate, the New York Women's Forum, the ULI-Urban Land Institute, and the Association of the Bar of the City of New York (former Chair, Economic Development Subcommittee, Land Use Planning and Zoning Committee). She serves as co-chair of the Practising Law Institute's 'CMBS for the Real Estate Lawyer' annual conference.

Ms Kane was honoured as 2017 Law360 MVP in Real Estate, the 2012 'Best in Real Estate' at the Euromoney Legal Media's inaugural Americas Women in Business awards, 2009 Woman of the Year by WX – New York Women Executives in Real Estate, and was named one of the top 50 women in real estate and one of 25 current leaders in the industry by *Real Estate Weekly* and the Association of Real Estate Women. *Grid Magazine* named her one of the top 10 American women in real estate development. Commercial *Observer* has twice cited Ms Kane, as part of its Power 100 list, as one of the 'Power Attorneys', the top real estate lawyers who are 'the legal world's most powerful, most connected and most exciting players'. In 2015, *Commercial Observer* profiled Ms Kane individually as one of New York's most influential real estate attorneys. She is cited as one of the leading real estate lawyers in the United States in *Chambers USA*, *Who's Who Legal USA*, *The Legal 500*, *The Best Lawyers in America* and numerous other peer-reviewed publications. She is a member of the prestigious American College of Real Estate Lawyers.

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PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

1285 Avenue of the Americas
New York 10019
United States
Tel: +1 212 373 3065
Fax: +1 212 492 0065
mjkane@paulweiss.com
www.paulweiss.com

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