

# REAL ESTATE GAZETTE

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**FOCUS ON:  
DISTRESSED ASSETS**

**CONSIDERING THE LEGAL IMPLICATIONS OF  
REAL ESTATE NON-PERFORMING LOANS IN  
THE NETHERLANDS AND ELSEWHERE**



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# A NOTE FROM THE EDITOR



## The twenty-fifth issue of the DLA Piper Real Estate Gazette highlights issues relating to distressed assets.

“  
The current real estate landscape continues to present genuine investment opportunities.  
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**A** very warm welcome to Issue 25 of DLA Piper's *Real Estate Gazette*. The global real estate market is currently operating against a backdrop of economic uncertainty. Brexit, immigration and presidential elections in the US all combine to create an environment in which you would not normally expect real estate to prosper; but historically low interest rates and the volatility of equity markets continue to push money into real estate. However, the real estate investment world is anything but homogenous. Stable economies like the US, Scandinavia and Germany attract institutional investors in search of "safe investments" and the search for the right product has caused a significant yield compression. On the other hand, there are economies, like Italy and Spain, and to some extent also the Netherlands and Belgium, which are still "recovering" from the repercussions of the financial crisis, in one way or another. In these countries the term "distressed real estate" is as relevant as ever. Investments in non-performing loans or joint ventures between lenders and borrowers (taking a significant haircut just to safeguard a minimum part of their investments) and new equity providers pushing for two-digit returns, are dominating features of the real estate market.

This issue of the *Gazette* focuses, therefore, on the legal aspects of investments in distressed real estate. In Denmark, for example, the demand for residential real estate, especially in the urban areas in and around Copenhagen, is as high as before the financial crisis and our article (on page 6) highlights the advantages, and risks, of converting distressed industrial properties to buildings suitable for residential use. In Germany, a considerable uptake in multi-jurisdictional portfolio transactions is noted (page 8), whilst Poland highlights the new opportunities available under the simplified bankruptcy procedures recently introduced there (page 16). In Ukraine meanwhile, regulatory measures taken by the Ukrainian Government to rehabilitate the country's banking sector have led to real opportunities for those investors in non-performing loans seeking new locales which offer value for money (page 22). In summary, the study of distressed assets which forms the focus of this issue, far from being a story of doom and gloom, in fact, indicates that the current real estate landscape continues to present genuine investment opportunities for investors with the right skill set.

Other topics considered in this issue include: the new Australian property taxes applicable to foreign purchasers of residential real estate (page 24); forthcoming changes to the legal framework applicable to pension funds in Italy (page 28); and the effect of Brexit on open-ended commercial property investment funds in the UK (page 32).

We do hope that you will find these topics interesting and if you would like more information on any of the matters discussed in this issue, please do contact our contributors. You will find their contact details on the opposite page.

Olaf Schmidt, Co-Chair, Global Real Estate Sector

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# COMMERCIAL PROPERTIES TO RESIDENTIAL PROPERTIES—TURNING AROUND DISTRESSED ASSETS IN DENMARK

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Occasionally, it may prove difficult for owners of Danish industrial or office properties to find a suitable, long-term and reliable tenant. However, the demand in Denmark for residential real estate, especially in the urban areas in and around Copenhagen, is as high as before the financial crisis. The prospect of a considerable financial yield from renting out residential properties is an important factor in persuading property owners to carry out

the building work required to convert commercial properties into those fit for residential use. Such a conversion could constitute an alternative exit strategy for real estate investors looking to release themselves from distressed properties with static or negative value growth.

## **Distressed properties**

Outsourcing, as well as an increased need for custom-built industrial buildings, have left generically designed industrial buildings unoccupied. While the lack of rental

income from tenants alone means less profit, larger industrial complexes may also incur different additional costs depending on the purpose and operations of the buildings. Properties burdened by fees and difficulty in finding a suitable tenant will rarely have more value for a potential buyer than for the original investor: Office buildings may be comparatively cheaper in maintenance costs, but with no long-term tenant, the prospect of collecting no rental income will in most cases be unattractive to a potential buyer.



### A rising trend

In recent years, former industrial areas and office buildings in Copenhagen have been under construction to create attractive, high-end residences in a city where demand for housing far exceeds the supply. Indeed, the same phenomenon can be observed all over the country, as several provinces are gradually becoming the sites for similar projects. In some cases, old factories are converted into residences while maintaining the spirit, if any, of the former use of the buildings. Other projects are being carried out on a larger scale, where entire areas comprised of several industrial sites become whole new housing estates.

### Advantages and challenges

Moving real estate from a low-demand market to a high-demand market has the obvious effect of increasing the potential price of the property and correspondingly the return on investment in the property. As the distressed properties are cheap, the potential return is significant. Many players on the market have already observed the impact of the trend, which has paved the way for easier

routes to finance for such projects.

Additionally, real estate conversion may provide several VAT related reliefs. For more on this, see Michael Neumann and Niclas Holst Sonne, 'What is a 'development site?'' *Real Estate Gazette* (Issue 20, 2015) page 18 ff (print) and page 30 (z-mag).

Hindrances and the extent of the challenges they present will typically be specific to the individual property. For some, the restoration of contaminated soil or contaminated adjacent bodies of water present both an expensive and difficult task. However, local authorities may insist that such restoration be carried out before they will allow the property owner to commence works on the site. Other factors, such as local law and practice of the municipality concerned, as well as national environmental, planning and zoning legislation must all be taken into consideration as well. Clearly, the process of converting property from commercial to residential is one that presents many challenges.

It is worth noting that although office buildings will often meet fewer practical challenges as less work is required to divide them into habitable units compared to industrial buildings, both are largely subject to the same rules governing the conversion of real estate from commercial to residential use.

### Some particular risks

#### Older properties

Older properties may require particular care as the age and condition of such properties may mean that unforeseen complications arise along the way to delay the process. Further, these properties may be subject to serious restrictions on renovation or conversion works by the Ministry of Culture.

#### Construction errors and materials

The materials used in the construction of the building and the very method of construction are both worth careful consideration at the outset. There have recently been issues reported surrounding the use of MgO (magnesium oxide) wallboards, and there are also occasional discoveries of construction errors in larger properties. Moreover, the use of wrong or unsuitable materials may have a damaging environmental impact on the surrounding areas. As the remedial measures necessary to correct such errors can be very expensive, a thorough technical due diligence of the property prior to investment is highly recommended.

### Impact of local area

Local development plans are produced on a municipal level and thus may be determined and altered as the political composition of the municipal council changes. Often municipalities will review construction applications on a case-by-case basis and allow political ambitions in the local area to influence the decision, which may cause some uncertainty as to whether the necessary approvals may be issued at all. Conversely, in some municipalities, conversion projects may be aligned to local interests making local authorities more cooperative. Clearly, a thorough legal due diligence of the property in question should be undertaken prior to investment.

### Burdens

While easy to ignore, some properties may be subject to registered burdens that hinder the use or intended use of the property. To ensure the smooth running of any conversion project, it is desirable for the property owner to consider the burdens, if any, before going ahead with the project.

### Conclusion

Owners of distressed industrial or office buildings may consider converting the buildings to those suitable for residential purposes, as the prospect of leasing or selling such properties is often more promising than is currently the case for industrial or office buildings. Despite the complex nature of larger conversion projects, with the right technical and legal advice to overcome the practical and legal challenges that may arise, projects may be completed within a reasonable timespan. For investors with a short-term exit strategy, the bulk of the profits to be attained by converting may already be achieved once the necessary permits have been obtained and the project planned in sufficient detail. Thus, though large-scale projects from start to finish may be lengthy, investors are not necessarily forced to commit their resources throughout the entire process.

In summary, converting industrial and office buildings can be a lucrative way for investors to turn around their portfolio of distressed assets. Nevertheless, there is an extensive body of legal rules surrounding such conversion work, making it highly advisable for investors to secure the relevant legal, technical and environmental expertise before investing in distressed industrial and office buildings for this purpose.

*Horten is DLA Piper's focus firm in Denmark.*

# LEGAL ASPECTS OF MULTI-JURISDICTIONAL NPL TRANSACTIONS

DR DIETMAR SCHULZ, FRANKFURT AND MUNICH,  
AND TOM BRAEGELMANN, BERLIN

**T**he acquisition of non-performing loans (NPLs) secured by real estate can be attractive. Recently, we have seen a considerable uptake in multi-jurisdictional portfolio transactions. Such transactions are complex and require a considerable amount of due diligence for both vendors and investors. Cross-border lending is often based on Loan Market Association (LMA)-style finance documents, amended to comply with local law, and perfection of security often requires strict compliance with local regulations. This article highlights some key aspects of multi-jurisdictional portfolio transactions.

## Due diligence

Some noticeable changes can be observed in the NPL market in Europe. There are far more cross-border transactions, with a much broader multi-jurisdictional scope. Also, there is an increasing desire for a complete closing by transferring the full contractual relationships, as opposed to mere assignments of loans/receivables. Assignments tend not to be the preferred route to closing because transfer secures both full control by the acquirer and full release by the transferor. In order to avoid pitfalls at closing, due diligence is required not only in relation to validity and enforcement but increasingly, also to transfer. As many multi-jurisdiction loan agreements are based on LMA-style documents, these often include transfer provisions and even transfer forms, but not necessarily for the transfer of the full loan connection including security and business roles. Also, not all courts, especially those in Central and Eastern Europe, are used to LMA-style documentation. This means that issues which might be clear, say in the UK, may not be so clear in Hungary or Romania.

Care is required when collateral and business roles are also being transferred.

There may be specific eligibility criteria which may not be met by everyone, such as “Qualified Lenders”. Resignation from business roles can be problematic, depending on the role. The transfer of the facility agency role can normally be accomplished more easily and quickly than the transfer of the role of the security agent.

Transfer forms do not generally provide for the transfer of collateral. Particular care needs to be taken regarding continuing security. Some collateral is deemed strictly accessory to the underlying debt and may get lost if not properly transferred. This can be addressed at closing by using a master transfer agreement based on transfer forms. Local law may also require compliance with particular formalities. This needs to be taken into consideration and can be costly. If at closing security cannot be transferred to the acquirer of the loan (or a new security trustee), then the holder (either the old lender or security agent) will need to keep it and will have to continue to act as a security trustee—the role of such a continuing security trustee must first be carefully reviewed and then re-negotiated in order to fit to the new structure.

Last, but not least, NPL investors will wish to have the acquisition of liabilities limited to those disclosed. Again, this is a question of due diligence, and the documents and data made available for due diligence. It is fair to say that fair disclosure ensures comfort on both sides of the transaction, and, hence, is to be encouraged.

## Consent requirements

Often, transfer of business roles requires instructions from majority lenders which needs to be arranged in a timely manner. Other potential hurdles are consent, co-operation or consultation requirements

which may even have different meanings in different jurisdictions.

Further, the consultation requirements may cause delays in various jurisdictions. A general observation is that transfer provisions have not often been tested in courts across Europe and this creates a certain level of uncertainty, particularly if not all parties are co-operative.

## Closing and elevation

Based on their due diligence, both seller and purchaser are advised to agree on





an elevation protocol outlining the form and substance of the actual transfer of the loan portfolio. As a contingency, it is advisable for the parties to agree on an alternative transfer method if the full transfer fails, such as an assignment of loan receivables only, or a funded sub-participation. In all cases, the asset management would have to be transferred as well. In practice, both sellers and purchasers of NPLs should take time to properly prepare the elevation protocol, in order to

secure an effective transfer of the full loan connections. Again, borrower consent remains key. This may already have been granted in the original loan documentation. Such prior consent is more likely to have been granted in older finance documents.

If the acquisition requires financing, the elevation protocol may also consider and provide for a transfer mechanism that allows the ultimate lender to take and to perfect security over the loan assets.

### The importance of documentation

In multi-jurisdictional NPL deals, the quality of the documentation may vary. Documentation may be lost or mishandled, and notarized documents and seals may be damaged and thus lose their evidentiary value. It is therefore crucial to ascertain what documents are required to commence enforcement proceedings.

Some jurisdictions (notably Switzerland, Germany and Belgium) require original deeds. However, many others will accept copies. While German law certificated land charges (*Briefgrundschulden*) can be transferred without registration of the transfer, it is standard practice to register the transfer of certificated land charges in the German land register—this will result in additional legal costs.

### Conclusion

Modern NPL transactions involving real estate as collateral are cross-border and multi-jurisdictional transactions. The goal is to close by transferring in full the assets of the loan portfolio (loan receivable and security) together with all accompanying business roles. Due diligence is crucial. Each jurisdiction will have its own rules on transfer, documentation and particular legal hurdles for parties to overcome. These all need to be addressed in the closing documentation.

Key to successful NPL transactions is obtaining excellent, wide-ranging legal advice and undertaking comprehensive due diligence. Proper due diligence will form the basis for a complete and swift elevation of the loan portfolio to the transferee. A welcome side effect of proper due diligence for both vendor and buyer, is not only a more transparent closing process, but also a quicker and more secure closing.



# THE NPL MARKET IN ITALY

UGO CALÒ, GIAMPIERO PRIORI  
AND MARTINA FRANCHINI, MILAN

**A**n overview  
The increase of non-performing loans (NPLs) (ie loans in arrears, restructured loans, “watchlist” loans and default loans) within the banks’ balance sheets is one of the clearest indicators of the crisis affecting the financial system.

Indeed, the economic downturn of recent years—as evidenced by (i) the decline in GDP, (ii) increasing levels of unemployment, (iii) greater use of the insolvency procedures, (iv) the ever-greater reserves required within the banks’ balance sheets, (v) the banks’ difficulty in securing financing within the interbank market, and (vi) the (only recently ended) spread increase—has unavoidably been reflected in the increasing prevalence of NPLs in banks’ balance sheets. Ultimately, NPLs constitute a drag on economic activity, especially for countries that rely mainly on bank financing, as is the case in Italy, because they reduce profitability, increase funding costs and tie up banks’ capital. All these factors result in a dampening of the credit supply and economic growth.

Nevertheless, the NPL disinvestment process by the banks (known as “deleveraging”) has until now been hampered by the misalignment of the prices expected by the banks (transferors) and investors (transferees). Only recently (and thanks to the efforts of, among other, the regulators to align such expectations) have institutional and private investors shown an increasing interest in investing in NPLs originated by Italian banks.

As a consequence of this, and also the increased regulation and the capital requirements introduced by Basel III, Italian banks have started to transfer such distressed assets to entities more able to mitigate the losses, if any, related to portfolios or single loans, and with the expertise to manage NPLs in a more efficient way. Such transfers, on the one hand, serve to reduce risk-weighted assets and management costs and, on the other hand, improve the liquidity ratios of the credit institutions.

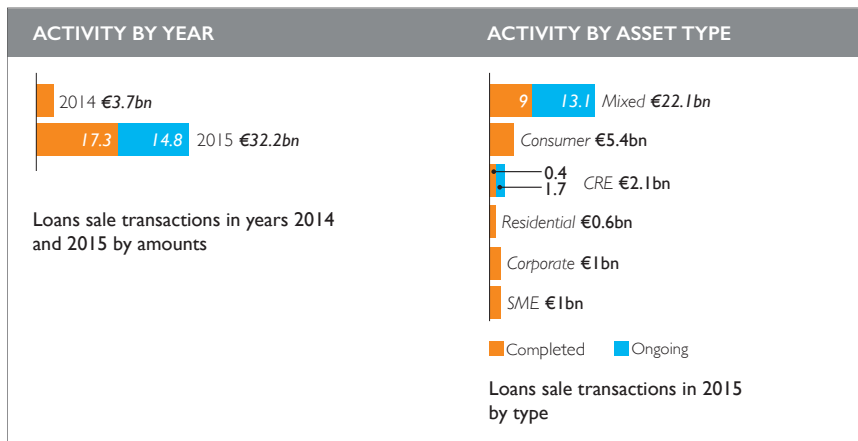
To help reduce the burden of NPLs in the banking sector and improve its profitability, thereby driving a gradual economic recovery, the Italian

Government has introduced a package of legislative provisions aimed at making the Italian NPL market more attractive to market players. This is achieved by improved judicial procedures, shortened foreclosure times, facilitation of NPL portfolio funding (“*Garanzia Cartolarizzazione Sofferenze*” (GACS) is a new guarantee scheme for the securitization of NPL purchases) and improvements to the relevant tax regime.

Such an approach definitely increases the value of NPLs, making them more attractive for investors and significantly reducing the likelihood of creditors’ losses. The success of this approach is clear from the number of completed NPL transactions, a figure which quadrupled in 2015 compared to 2014.

The forecast for the current year remains positive with the larger Italian banks carrying on with their deleveraging plans (identifying which assets to hold, restructure or sell), the economy continuing its recovery, price expectations becoming more realistic and the outlook for the real estate market steadily improving.





### The acquisition structure

The purchase and servicing of NPLs may be undertaken only by banks and other authorized entities, namely:

- (i) financial intermediaries enrolled in the register kept by the Bank of Italy according to article 106 of the Unified Banking Law (the "106 Intermediary"); and
- (ii) alternative closed-ended investment funds ("AIFs") as defined by the Unified Financial Law and which may

be established by contract (ie asset management companies) or under statute (ie a SICAF, or *società di investimento a capital fisso*, similar to a joint stock company).

In relation to the first entity, the 106 Intermediary, one of the most common acquisition structures provides for the owner of the NPLs (usually banks or other credit institutions) to set up a virtual data room (VDR) containing all the finance documents related to the NPLs (facility

agreements, mortgage loan agreements, bank accounts agreements, mortgage agreements, security documents such as mortgage agreements, pledge agreements, deed of assignment by way of security, patronage letters, etc) and, if any and if commenced, all documents relating to the enforcement procedures.

The seller will then invite all potential purchasers to consult the VDR for their respective due diligence activity in order to better assess the quality and the quantity of the NPLs. Having reviewed the relevant documents, the potential purchaser is invited to make the seller an offer for the NPLs, setting out its terms and conditions.

Once all the offers received have been considered, the seller will choose the best proposal, and negotiation and drafting of the assignment agreement will commence. The assignment of NPLs is generally effected by means of a securitization vehicle (SPV), which is required to be a 106 Intermediary, introduced by Law 130 of 30 April 1999 (the "Securitization Law") which will be backed by Receivables deriving from the



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In the securitization structure, the investors would not be the direct beneficiary of the securities granted by the borrower and its guarantors.

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assigned NPLs and funded by way of underwriting notes (the “Notes”) issued by the SPV.

The proceeds of the subscription of the Notes are used by the SPV to pay the purchase price for the assignment of the Receivables. It should be noted that the obligation of the SPV to make payments under the Notes will be limited to the amounts received or recovered in respect of the Receivables and the other monetary claims of the SPV in relation to the transaction.

In the securitization structure, the investors would not be the direct beneficiary of the securities granted by the borrower and its guarantors, including the mortgages on the immovable assets. This security would be held directly by the SPV and the Receivables represent segregated assets of the SPV that can be used only for the repayment of the Notes and the other transaction-related costs.

It should also be noted that under the Securitization Law, as a derogation of the general provisions of:

- (i) the Italian Civil Code, in relation to the assignment of receivables, a simplified notice mechanism applies in relation to the notice of the assignment to the debtors of the Receivables; and
- (ii) the Italian Bankruptcy Law, in relation to claw-back actions applicable

to a securitization, a shortened term for the expiry of the claw-back period of three and six months (instead of one or two years) applies.

### Enforcement procedure

#### Foreclosure proceedings on mortgaged real estate: general overview

Under the Italian Civil Procedure Code (ICPC), the foreclosure proceedings on mortgaged real estate generally follow the following steps:

- (i) Default notice: the secured creditor sends the debtor a formal notice of default, generally via registered letter, requesting the immediate (generally within 15 working days) payment of the outstanding debt including any interest and expenses.
- (ii) Service on the debtor of the order of payment (*atto di precetto*) and an enforcement order (*titolo esecutivo*): the foreclosure proceedings are preceded by the service of an enforcement order which may be constituted by the deed under which acknowledgment is made of the drawdown of the mortgage loan (*atto di erogazione e quietanza*), a public deed (*atto pubblico*), or a deed certified by a notary public (*scrittura privata autenticata*). The order of payment is an order addressed by the

creditor to the debtor; to perform the obligation indicated in the enforcement order no later than 10 days from service of the order:

(iii) Attachment of immovable assets (*pignoramento immobiliare*): a deed of enforcement of the attachment (*atto di pignoramento*), which indicates the relevant attached assets and the rights over such assets, must be served on the debtor. Once that is served, the following events take place:

- (a) the judicial officer (or the creditor initiating the foreclosure procedure) registers the pleading of attachment with the relevant land register and deposits a copy of the pleading with the court’s clerk office;
  - (b) within the next 10 days, the enforcement order and the order of payment must be filed with the clerk office;
  - (c) the attached assets are placed in custody (note that the debtor may be appointed custodian of the relevant asset); and
  - (d) the foreclosure procedure formally begins.
- (iv) Motion for sale: Not earlier than 10 days from service of attachment on the debtor and not later than 90 days following such service, the creditor who has initiated the foreclosure



process, and the intervening creditors, must file a motion for the sale of the attached assets. Within 120 days as from the filing of the motion, the creditor requesting the sale must file the relevant abstract from the land registry, as well as the certificates of registration related to the attached immovable asset, covering the last 20 years; such documentation may be replaced (and generally is replaced) with a certificate issued by a notary public, assessing the outcomes of the search carried out in the land registries.

(v) Determination of the value of the foreclosed asset: the foreclosure judge appoints an independent expert appraiser to assess the asset's market value. The asset's market value is then generally used as the base/minimum price for sale purposes.

(vi) Sale: the foreclosed asset is put up for sale, with the aim of achieving its fair market price. Generally, the asset is put on a "closed envelope" sale (*vendita senza incanto*) where the base/minimum price is determined by the judge (in the light of the appraisal mentioned above). Where the "closed envelope" sale is unsuccessful, the asset is put up for auction (*vendita con incanto*). Where both sales prove unsuccessful, the base/minimum price

is generally reduced by 20 per cent and another sale begins.

(vii) The possible appropriation of the properties: satisfaction of creditors may occur by means of a forced sale of the foreclosed assets as well as, in some circumstances, by means of appropriation of the foreclosed assets. At least 10 days before the auction sale, any creditor may file a petition for the appropriation of the properties in the event the auction sale does not take place because of lack of any offers. Where this happens, the judge may, during the hearing scheduled for the auction sale (and in the absence of any offers to buy the asset at the base price) decide immediately on the petition for appropriation. If there is no petition for appropriation or the judge decides to not accept it (it is completely at the judge's discretion) the judge must initiate a whole new sale, starting again from the "closed envelope" phase, this time reducing the price by up to 25 per cent. Pursuant to Article 589 ICPC the price offered for appropriation may not be lower than:

- (a) the expenses for the proceedings plus the total amount of the secured credits ranking higher than that of the offering creditor (Article 506 ICPC); or
- (b) the base/minimum price (Article 568 ICPC).

### Timing and costs

According to statistics published by the Bank of Italy, the completion of foreclosure proceedings on mortgaged real estate properties takes on average about six years, although the time taken may vary significantly depending on the type and location of the properties and other factors (such as the efficiency of the competent courts, their workload, etc). Thus, foreclosure proceedings on real estate located in Milan, for instance, take on average three and a half years.

All costs connected with the foreclosure proceedings (namely, legal fees, costs of certificates, notarial costs for land register certificates, costs of the independent expert appraiser) are borne by the creditor. The legal fees connected with the foreclosure proceedings are based on rates provided by Ministerial Decree 55/2014 which provides for a range of applicable fees connected with the value of the asset and the activities undertaken. Based on an asset value of €10 million, the legal fees may range between €15,000 and €20,000. It should be noted that these figures do not include the costs of challenging any opposition that the debtor/borrower may raise.



# LEGAL ASPECTS OF INVESTING IN NON-PERFORMING LOANS IN THE NETHERLANDS

RUTGER ORANJE AND KIRSY CORTEN, AMSTERDAM

## Introduction

In the Netherlands (and other European countries), selling and buying (real estate) non-performing loans (NPLs) portfolios is on the increase. The first significant Dutch NPL portfolio, known as Project Lucas, was sold in September 2015 (for €420 million). Currently Lone Star Funds is buying Propertize, a “bad bank” with loans of more than €4 billion. Additionally, Dutch Rabobank has announced its intention to reduce its entire loan portfolio by approximately €100 billion by 2016/17. These circumstances have led to a growing enthusiasm from (foreign) investors for investing in NPLs in the Netherlands.

The purchase of NPLs is often combined with the purchase of distressed assets or performing loans. A (non-performing) loan portfolio is often used as security for the third party financier and/or for

sub-participations. One advantage of purchasing NPLs in the Netherlands is that no transfer tax (charged at 2 per cent on residential properties and 6 per cent on commercial properties) is payable.

Under Dutch law, it is possible to transfer both the rights and obligations under an agreement to another party by means of an assumption of contract (*contractsoverneming*). It is also possible to transfer (only) the rights under an agreement by assignment (*cessie*).

## Assumption of contract

In the event of an assumption of a loan agreement, all rights and obligations under the agreement (including the benefit of security rights other than suretyship or third party security rights) will be transferred to (and assumed by) the transferee. Following the transfer, the transferee will benefit from all

contractual rights and obligations under the loan agreement as if it had been an original party to the agreement.

For a transfer to take place, the cooperation (which can be construed as consent) of all counterparties is required. The loan agreement often expressly provides that a debtor will consent in advance (*medewerking verleent bij voorbaat*) to such a transfer should circumstances demand it. This is usually included in the loan agreement itself or in the general terms and conditions that are applicable to the loan agreement.

## Assignment

The transfer of rights by assignment is only considered desirable when the creditor does not cooperate (in advance). Whilst the assignment of rights under loan portfolios is often achieved by means of an undisclosed assignment (*stille*

cessie), it can also be done by means of a disclosed assignment (*openbare cessie*). The advantage of the latter is that, as soon as the debtor has been notified, the debt can only be discharged by payment to the assignee.

However, an assignment does not give the assignee the full benefit of all contractual terms agreed between the original parties to the loan agreement, since the assignor remains the formal counterparty of the debtor in all relevant documents. Nevertheless, the assignee would become the creditor of the claim after assignment and that would include the right to claim (re)payment plus interest.

Following an assignment, the contractual relationship between the original lender and the debtor remains in place. The debtor is obligated to fulfil any obligations (not relating to payment) under the loan agreement to the original lender. Equally, the original lender is also obliged to meet any obligations it may have under the loan agreement to the debtor. In addition, any claims (tortious or otherwise) that the debtor may have will still need to be brought against the original lender. As the contractual rights and obligations (other than payment) still remain with the original parties, the sale and purchase agreement of an NPL will need to provide for, for example, exclusive mandates (*privatieve lasten*) and powers of attorney in order to give the assignee the fullest possible benefit of the contractual rights remaining with the assignor. It should be noted that the assigning lender is usually reluctant to give such mandates, powers of attorney or to assume assignor liabilities.

### Loan portfolio as collateral

If a loan portfolio can be transferred, these loans should also be capable of being transferred to another party. Under Dutch law, it is not permitted to transfer claims as a means of security. Instead, a right of pledge is created over such claims against debtors with the third party financier as pledgee.

If assignability is excluded and a transfer of contract is not possible, an economic rather than legal transfer would need to be implemented. This could be achieved by a sub-participation. In the Netherlands, the transferee will always be exposed to the insolvency risk of the transferor.

### Accessory rights

All rights that are accessory to the transferred claim, either through assumption or assignment, will (automatically) transfer to the assignee by operation of law. Unfortunately,

there is no clear definition of the term "accessory rights", either in the legislation or case law. However, the Dutch Civil Code does state that the security rights purporting to secure the transferred claim are accessory rights, hence the transferee is entitled to the benefit of such rights. In addition, the transferee will have the full benefit of any interest or penalty arising under the contract, or any periodic penalty payment imposed by the court (other than those amounts due and payable at the time the transfer takes place). A mortgage and a right of pledge are good examples of accessory rights under Dutch law. When a mortgage is transferred with the transferred claim, it has to be re-registered with the land registry in the name of the assignee by a Dutch civil law notary. This is not however a legal requirement for the transfer of the claim.

Since there is no exhaustive legal definition of accessory rights, it cannot be stated with any certainty which rights are accessory (and will therefore transfer with the claim). However, it may be argued that any right that is beneficial to the transferee in respect of its claim and its security rights will also be transferred by operation of law.

### Enforcement of mortgages

Investors in NPLs must be aware that the cooperation of the debtor will normally be required in order to divest the underlying assets, since a mortgage has to be enforced by public auction by a civil law notary under Dutch law. It is possible to sell the assets through a private sale, but only with consent of the court. Moreover, the Dutch Civil Code prohibits appropriation (*toe-eigeningsverbod*), meaning any clause purporting to allow a pledgee or mortgage holder to appropriate the encumbered property is null and void. This is different to the legal position in most other European countries, where there is no such prohibition.

### Conclusion

In conclusion, NPLs can be transferred under Dutch law by means of an assumption or an assignment. All accessory rights to the transferred claim, such as a mortgage or a right of pledge, will also be transferred by operation of law. Attention must be paid to the legal rules relating specifically to the enforcement of NPLs, especially to those relating to the prohibition on appropriation. NPLs continue to be seen as an interesting asset class in the Netherlands, but it is important for investors to be aware of the legal implications of investing in these loans.

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# NEW OPPORTUNITIES UNDER POLISH BANKRUPTCY LAW

ANNA KRZANICKA, WARSAW

**O**n 1 January 2016, substantial pro-business legal reforms were implemented to address the dissatisfaction of creditors with costly and lengthy bankruptcy proceedings in Poland. These reforms comprise significant changes to the existing Act on Bankruptcy and the entry into force of an entirely new Act on restructuring that contains a raft of new rescue and recovery processes inspired by the English and US models. They are intended to introduce a real “second chance” policy in Poland. One of the most important changes is the introduction of a new concept in the Polish legal system—the “pre-pack”.

The pre-pack is also known as “simplified bankruptcy proceedings”, during the course of which a debtor’s business or part of it can be sold on the declaration of bankruptcy or within three months of that declaration. In addition, specific assets that form a substantial part of the debtor’s business can also be sold. This includes real estate, so that the pre-pack may be viewed as providing significant opportunities for those dealing in real estate.

But there are some exceptions. For example, this general rule does not apply to assets encumbered with a registered pledge, although this only applies if the pledge agreement expressly provides that the pledgee may take over the object of the pledge (in the event of the debtor’s failure to meet its liabilities). This means that if the debtor’s business is encumbered with a registered pledge under which the pledgee may take over

the object of the pledge, that business cannot be sold in the course of simplified bankruptcy proceedings.

As with a petition for declaring standard bankruptcy, a petition for declaring “simplified bankruptcy” may be filed by the debtor or the creditor. In both types of bankruptcy procedure, the petitioner must prove that the debtor is insolvent. Under the Act on Bankruptcy the debtor is insolvent if: (i) it is no longer able to meet its liabilities as they fall due or (ii) its liabilities exceed the value of its assets and this state of affairs lasts for a period exceeding 24 months.

But there is an additional requirement for the simplified petition. Such a petition must be accompanied by a petition confirming the conditions of sale of the debtor’s assets. This petition must specify: (i) the debtor’s assets which will be the subject of the sale agreement, (ii) the price of those assets, and (iii) the entity that is interested in buying individual assets. These requirements are also considered to be met if the petitioner files a copy of the sale agreement with the court.

The potential purchaser of a debtor’s business is often interested in purchasing the ongoing business as quickly as possible—and this is where the pre-pack comes in. In the course of simplified bankruptcy proceedings, the debtor’s business activity continues unaffected.

Under the simplified procedure, the debtor’s business is not adversely affected by the lengthy standard bankruptcy proceedings. In standard bankruptcy proceedings, the court appoints a trustee to take control of

the debtor’s assets. At the beginning of the proceedings, the trustee chooses a court expert who prepares a valuation of the debtor’s business. In general, the debtor’s assets should be sold as one lot (ie not as separate parts). This means that the trustee should, at least initially, look for a purchaser who is interested in buying all the debtor’s assets, even if this turns out to be not possible. This process usually takes about two years, during which time the value of the debtor’s assets decreases. Of course, this situation may be beneficial to potential purchasers because they can then buy the debtor’s assets for a price lower than the market value. In the report prepared by the court expert, two different values are usually indicated—the market value and the liquidated value. In reality it is impossible to obtain the market value in the course of bankruptcy proceedings.

It should be noted that simplified bankruptcy proceedings also protect creditors. Under the Act on Bankruptcy, the valuation prepared by the court expert should be attached to the simplified bankruptcy petition and on that basis, the court can consider whether or not the proposed price is detrimental to the creditors.

In addition to being bought by a third party, the debtor’s assets can also be bought by a related entity, for example, a shareholder of the debtor or its controlling company. However, if the potential purchaser is a related entity, the sale price cannot be lower than the price indicated by the court expert in the valuation. This means that if the potential purchaser is not a related entity,





the sale price may be lower than the valuation price, but it should be higher than the amount obtainable in standard bankruptcy proceedings minus the costs of those proceedings. Therefore, the price should be higher than the amount which would be distributed among the creditors as a result of standard bankruptcy proceedings. This means that a petitioner who is not a related entity should prepare an estimate of the costs of the standard bankruptcy proceedings. This is not especially difficult to do because in the course of bankruptcy proceedings there are some fixed costs, such as the remuneration of the trustee or the costs of redundancies.

It could be very important for the potential acquirer to take control of the debtor's business as quickly as possible. In the course of the simplified procedure, the purchaser can take over the debtor's business on the declaration of bankruptcy, however, that is only possible if proof of payment of the full price into the court's deposit account is attached to the petition.

The simplified procedure can be used by an entity that is interested in acquiring an ongoing business. For example, consider the situation where the debtor is the owner of a shopping mall. The debtor has become insolvent and does not have enough money to pay bills related to the running of the mall. As a consequence, the electricity and water companies cut off their utilities, meaning that the mall's tenants cannot conduct business there and they start making losses. As a result, the tenants demand contractual penalties from the owner (ie the debtor) on the basis of

their lease agreements, which forces the owner deeper into financial trouble (not to mention the increasing losses being made by the tenants themselves). With the new pre-pack solution, the debtor could file a simplified bankruptcy petition, the business activity could be continued without any break, the bills could be paid by the purchaser (even before the declaration of bankruptcy—this could be stipulated in the initial agreement between the parties), the tenants would not be exposed to losses, and the debtor would not sink further into insolvency. This approach has been used several times by Polish bankruptcy courts and is becoming increasingly popular.

Alongside the advantages of the pre-pack, there are, of course, some disadvantages. For example, a creditor interested in taking over the debtor's business could file a simplified bankruptcy petition, forcing the debtor to fight off the creditor's petition. However, it is important to point out that the simplified petition must include some information which is not available to all creditors, for example, the list of creditors or the valuation of the debtor's business. In general, in the case of a private company such information will only be available to secured creditors.

It is also worth noting that a simple way to block a petition filed by a creditor would be for the debtor to pay the sum owed to the creditor-petitioner, causing the petition to be dismissed for the creditor's lack of standing.

Another disadvantage of the pre-pack is that some judges may be afraid of declaring a simplified bankruptcy,

believing that it may be just another method of taking the most valuable assets from an insolvent business and recommencing business activity under a new name. These concerns are justified to some extent. However, it should be noted that the Polish Bankruptcy Act does not stipulate that the debtor's business can be bought only by a third party. That is not the aim of the pre-pack. Its sole aim is to ensure the sale of the debtor's business at a fair market price on the declaration of bankruptcy. If the price is at the market level and the debtor's business is not adversely affected by lengthy bankruptcy procedures, then this aim will be achieved.

It remains to be seen how some elements of the simplified bankruptcy procedure will be implemented in practice. Nevertheless, the introduction of this mechanism into the Polish legal system should be seen as a positive step. The main disadvantages of standard bankruptcy proceedings are that they are very time-consuming and that they do not always produce a satisfactory result. The substantial costs are no guarantee of significant satisfaction for the creditors (creditors usually receive only 15 to 20 per cent of what they are owed). The simplified procedure may bring about a radical change to this situation. It may substantially reduce the costs and allow businesses to carry on intact. It is also very important that in the course of bankruptcy proceedings (both standard and simplified), the acquirer of the business acquires it free from any encumbrances and does not assume any prior liabilities.

# PRACTICAL ASPECTS OF NPLS AND REOS PORTFOLIO DEALS IN SPAIN

ORSON ALCOCCER, MADRID

**A**ny discussion of distressed assets will, almost certainly, feature Spain. In a country where house ownership is around 80 per cent, and in which more homes were being built each year than in Germany, France and England put together; the global financial crisis decimated the real estate development market and increased the non-performing loans (NPLs) ratio from a stable 1 per cent pre-crisis to more than 10 per cent in 2012. This perfect storm saw the Spanish banks holding more than €500 billion of distressed assets at the peak of the crisis.

Thanks to a comprehensive restructuring of the Spanish financial sector, which included the creation of the Spanish “bad bank” Sareb, which absorbed more than €50 billion of distressed assets (mainly from the Spanish savings banks), and a process of bank concentration and recapitalization, the Spanish banks have been able to reduce the total volume of distressed assets to approximately €215 billion, of which approximately €85 billion are real estate owned properties (REOs).

This reduction in the volume of distressed assets has been achieved through unrelenting sales of portfolios of distressed assets, which in 2015 amounted to €15 billion. This figure is likely to reach €19 billion in 2016, and will continue to rise in order for the Spanish financial system to be able to recover from the crisis of recent years.

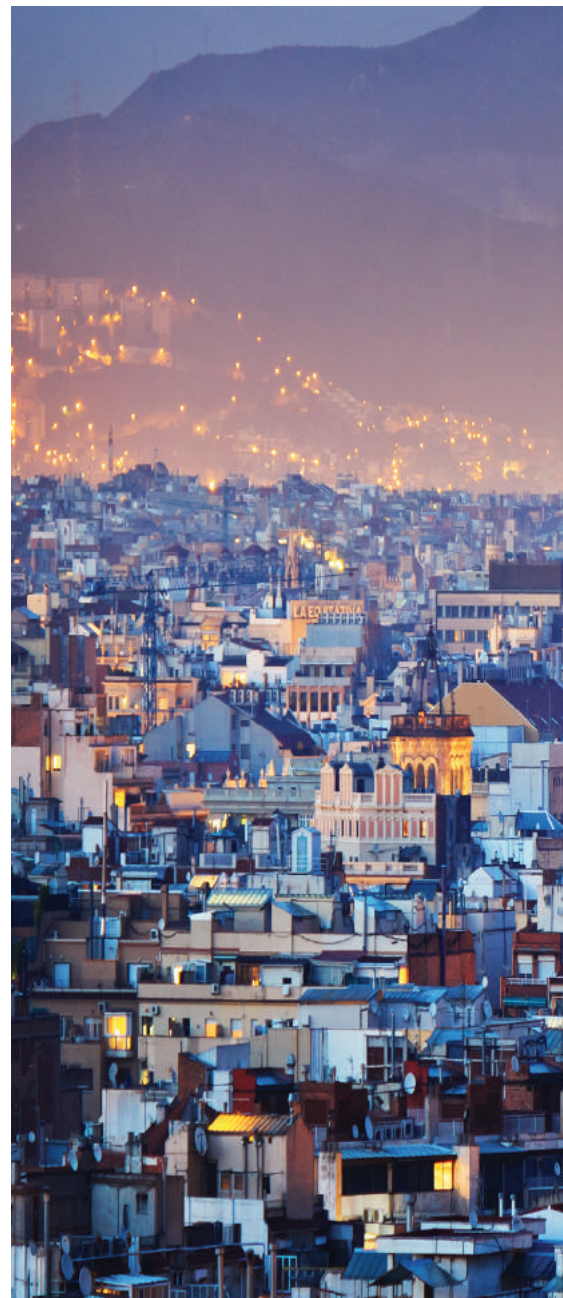
Although portfolio sales in Spain follow the same general process as in other countries (and in this area, credits are in general freely transferable

without specific formalities, other than those applicable to the transfer of the relevant security, and REOs acquired in compliance with the land registry system), there are several important practical issues which need to be taken into account by parties acquiring distressed assets in Spain.

The main problem that investors face in these transactions in Spain is the lack of documentation. It is undeniable that during the boom years there was a lending rush which made the control systems more lenient, with, for example no checks being undertaken to ensure security documentation was complete. This issue has been aggravated by the restructuring of the banks and distressed assets portfolios.

Incomplete documentation has a direct impact on price, as it prevents potential acquirers from making an accurate estimate of how long it will take for them to obtain the collateral in the case of NPLs (if, for example, lack of the relevant notarial deed precludes foreclosure of the mortgage through the expedited mortgage procedure) or for exploiting the REOs (if, for example, the relevant REO is not registered in the name of the seller).

Bankruptcy issues are the second main problem that investors need to address when contemplating the acquisition of NPLs in Spain. Not only there is a clawback risk which lasts for two years from the date of the declaration of insolvency for actions detrimental to the bankrupt estate, but the acquirer also needs to ensure that the NPLs which are being purchased may not be subordinated, and in general to be sure of the purchaser’s position within the



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Possible first acquisition and preemption rights must always be considered by parties acquiring distressed assets portfolios in Spain.

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debtor's existing or potential bankruptcy procedures.

After any issues of lack of documentation and debtor insolvency have been resolved, there remain several issues to consider:

Possible first acquisition and preemption rights must always be considered by parties acquiring distressed assets portfolios in Spain. In the case of an NPL, if the latter is considered a “contentious credit” the debtor may have the right to repay the debt at the discounted price paid for the NPL. As for REOs, there may be preferential rights for the benefit of possible co-owners, but it is particularly in relation to existing lessees that these rights may arise (with the added complication of the different lease regimes that may apply).

The transfer of REOs may also be affected by regulatory requirements, such as the need to have a first occupation permit in the case of residential properties located in certain regions, or the restrictions applicable to the sale of social housing.

Finally, and although this article does not attempt to consider the tax implications of acquiring portfolios of distressed assets, investors must be aware of the costs associated with the transfer of registered securities (and in particular the stamp duty applicable to the transfer of mortgages), of the various taxation implications of transferring residential properties and other real estate assets (it being especially important to ascertain whether VAT or non-recoverable transfer tax applies) and of potential taxation on interests.

# TENANT INSOLVENCY— HOW LANDLORDS SHOULD APPROACH A CVA

ROWAN ASPINWALL AND TIM DAWSON, LONDON

**P**olitical and economic uncertainty in the aftermath of the referendum result in the UK has dampened sentiment on the high street and hit consumer confidence. According to the National Institute of Economic and Research, there is an “even” chance of Britain falling into recession by the end of next year and the Bank of England has significantly reduced its growth forecast for 2017.

With the retail industry traditionally vulnerable in challenging economic times, landlords must be prepared and know how to deal with financially distressed tenants. Recent bricks-and-mortar retail insolvencies have, to varying degrees, cited high property costs as a partial cause of business failure and tenants have increasingly turned to company voluntary arrangements (CVAs) as a method of trying to restructure their businesses and reduce such costs. Recent examples include BHS and Austin Reed (although in both cases, the CVA proved insufficient to stop the companies entering administration).

In the current climate, aligning commercial landlords’ and retail tenants’ interests is increasingly difficult. Landlords must be mindful of the effect that the terms of a CVA proposed by a tenant might have for them, particularly given the “cramming down” effect of a CVA on dissenting creditors, as discussed below.

## What is a CVA?

A CVA is an insolvency and rescue procedure under Part 1 of the Insolvency

Act 1986. It allows for a company in financial distress to enter into a legally binding arrangement or compromise with its unsecured creditors. Typically a CVA will involve a rescheduling or reduction of the company’s debts, but a CVA can also change the wider contractual terms between a company and some or all of its creditors.

A CVA is a flexible and relatively cheap process requiring limited court involvement, albeit a qualified insolvency practitioner (known as a “nominee” before the CVA is approved and a “supervisor” once the CVA is effective) is required to implement and supervise the CVA. The supervisor does not take control of the company. The directors remain in office and are responsible for the ongoing trading of the company.

For a CVA to be approved, it must be voted for by at least 75 per cent by value of those of the company’s creditors who attend a creditors’ meeting (in person or by proxy) to consider the CVA proposal (and at least 50 per cent in value of the supporting creditors must be unconnected to the company).

It is important that landlords are aware that once approved (and subject to limited circumstances in which a challenge can be made), a CVA will bind all unsecured creditors regardless of whether they voted for or against the CVA and whether or not they attended the meeting. No unsecured creditor can take any step against the company to recover any debt that falls due within the scope of the CVA, once it is effective.

## How might a CVA affect landlords?

In a retail context, landlords do not often take security for the obligations owed by their tenants and so will usually be unsecured creditors of a company. A CVA can offer a mechanism that allows a tenant company to restructure its rent obligations or change the terms of its leases across some or all of its premises, often to the significant detriment of its landlords (and possibly without the consent of all of the affected landlords).

Landlords have had something of a love/hate relationship with CVAs. They are typically promoted by tenants on the basis that the CVA will offer them more than they would otherwise get if the tenant were to enter a more terminal insolvency process such as liquidation. The tenant will look to the positives of a CVA, such as its stores being kept open, rates continuing to be paid (so that the landlord is not having to pay business rates) and the landlord getting payment of some rent, which is better than no rent at all.

However, despite the majority of CVAs being successful—JJB Sports being an example of where the CVA proposal received overwhelming support by landlords and was seen as reasonable and transparent—there have been some where landlords have raised concerns, suggesting that the process was being exploited at their expense and being used to “dump” failing premises.

The flexibility of the CVA tool means that a tenant’s proposals might include anything from a reduction in future rent



or amendments to particular covenants in a lease, to more controversial proposals, such as seeking to remove a landlord's right to forfeit a lease or depriving them of valuable guarantee rights which they might have against a solvent parent company or third party. This last example of "guarantee stripping" was proposed in the Powerhouse CVA. Whilst, in that case, it was successfully challenged by its landlord creditors, the court did acknowledge that it would be conceptually possible for a CVA to compromise a landlord's right to claim against such third parties.

### Practical advice for landlords

Landlords must be mindful of the implications that the terms of a CVA proposed by a tenant will have for them. The CVA provides a framework for a binding arrangement (even on those who do not consent), but does not dictate the content or shape of a deal. If a landlord is faced with the prospect of one of its tenants entering into a CVA, it should do the following:

- Act promptly. A company proposing a CVA only has to give 14 days' notice to creditors of the meeting at which the creditors will consider and vote on the CVA proposal.
- Carefully review the CVA terms. Landlords should analyse the impact of the CVA in comparison with alternative insolvency regimes, such as liquidation. Every CVA will (to some extent) be unique, so careful scrutiny of its terms is key. A CVA can, under limited circumstances, be challenged within 28

days of its approval being reported if it unfairly prejudices a creditor (in the context of the overall effect of the CVA).

- Obtain the maximum value of any claim for the purposes of voting. A landlord's claim will usually comprise (i) a claim for arrears of rent (if any) that exist at the time of the CVA meeting; and (ii) a claim for future rent which has not yet fallen due and dilapidations. For the purposes of voting in the CVA meeting, the second element of a claim, being an unascertainable sum, will be prescribed a value of only £1.00, unless the CVA proposals state otherwise or the chairman of the creditors' meeting agrees to put a higher value on it. Landlords should be prepared to submit evidence for a higher value to be placed on this second element, for example where it is proposed that the company will vacate the premises, expert evidence of how long it is likely to take to be able to re-let the premises or, for dilapidations claims, a schedule with an independent assessment of the costs for remedying the issues.
- Consider (where possible) taking action against the tenant to recover possession of a premises before the CVA is approved. This may not be possible where the tenant is already in administration and the CVA is being proposed by the company's administrators or where the tenant is a small company, as such companies can seek the protection of a

moratorium as part of its proposing a CVA. This would prevent the landlord from taking steps to enforce any claim against the tenant (pending consideration of the CVA proposal).

- Seek out other like-minded landlords/creditors with whom it might be possible to act in concert, to reject or seek modifications to, a tenant's proposals.
- Inspect carefully the conduct of the CVA process and the creditors' meeting. In addition to a challenge for "unfair prejudice", a CVA can also be challenged (within the same time period) if there has been a "material irregularity" in relation to the conduct of the creditors' meeting or the CVA process.
- Perhaps most importantly, know its rights. CVAs are not always successful, so it is important that landlords know their rights in the event of a failure of the CVA and/or the tenant subsequently entering liquidation or administration.

A landlord's attitude to a particular CVA will differ from proposal to proposal and will depend (amongst other factors) on (i) the scale of the proposed changes; (ii) the market for its property; and (iii) the likely rental levels which may be obtained on a re-letting. However, to get the best protection and outcome when a CVA proposal is made by a tenant, landlords should consider and participate in the approval process for the CVA and fully exercise their rights to make representations and vote.

# UKRAINE: NPL INVESTMENT HIDDEN GEM?

DENISE R HAMER, LONDON, PRAGUE AND VIENNA

**A**t this time of year, the travel media entice us with articles about little known holiday locales—undiscovered islands, secluded villages and forgotten cities. All beckon holidaymakers with the promise of charm, authenticity, and most of all, real value for money. They are holiday hidden gems. As investors in non-performing loans (NPLs) also scour the globe seeking new locales which offer real value for money, Ukraine may prove to be an NPL investment hidden gem.

In the adjacent jurisdictions of Central and Eastern Europe (CEE) and South Eastern Europe (SEE), the banking sector's NPL ratios range from an estimated low of 3.5 per cent for Austria to an estimated high of 26.7 per cent for Bulgaria, with an estimated combined average for CEE, SEE and the Baltics of 5.7 per cent, according to a 2015 study by the World Bank. The relatively low NPL ratios mean less assets for sale, less price flexibility and less yield. Investing in Austrian NPLs is a bit like vacationing in London ... pleasant enough, but long queues and no bargains.

Ukraine's banking sector, however, has a jaw-dropping NPL ratio of 40 per cent as announced in April 2016 by the Deputy Governor of the National Bank of Ukraine (NBU). Even by the more conservative estimates of the World Bank, Ukraine's banking sector has an NPL ratio in excess of 28 per cent. Moreover, according to the NBU, over 70 per cent of Ukraine's banks are being restructured, consolidated and deleveraged. Such activity and relatively



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## Does Ukraine offer a legitimate investment opportunity or simply an immeasurable risk?

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high NPL ratio mean more assets for sale, more price flexibility and higher yield.

But does Ukraine offer a legitimate investment opportunity or simply an immeasurable risk? Is investing in Ukrainian NPLs a bit like vacationing on the lip of a lava spewing volcano? Untrammelled for sure, but likely to leave you scorched.

Ukraine's banking sector has long been plagued by corruption and mismanagement, as well as the more recent economic repercussions of a revolution, an annexation by Russia of Crimea, and separatist rebellions. Nevertheless, in compliance with the International Monetary Fund and working with the Vienna Initiative, the Ukrainian Government has taken, and continues to take, certain incremental legal and regulatory measures to steady the economy and rehabilitate the banking sector. Several of the recent measures have directly facilitated investment in NPLs.

With effect from 11 January 2016, the NBU implemented Resolution No. 996, which repealed a prohibition on the transfer of cross-border loans to Ukrainian borrowers denominated in foreign currency. This prohibition had been in effect since 20 August 2015, as a crisis measure following the devaluation of Ukraine's Hryvnia, and had suspended all trading in the Ukrainian secondary loan market relating to cross-border loans denominated in foreign currency. Resolution No. 996 now permits such cross-border loan transfers.

On 15 July 2016, Ukraine's President Poroshenko formally adopted Law

No. 3555 on Financial Restructuring, which addresses corporate financial restructuring. Amongst other innovations, the Law enables creditors and debtors to negotiate out-of-court agreements, corporate management to be replaced and corporate governance to be overhauled, and loans to be amended or extended. The Law is intended to expedite and streamline corporate financial restructuring by empowering creditors and reducing the influence of third parties.

Finally, 2016 saw the introduction of several amendments to existing tax legislation, initiating what will be an ongoing reform of the Ukrainian Tax Code, which is expected amongst other things, to grant preferential tax treatment for corporate write-offs.

With a population of 42 million, exceeding both the 38 million population of Poland and the 29 million aggregate populations of Romania and Hungary, Ukraine certainly represents a significant market. Polish and other CEE/SEE regional asset managers have expanded into Ukraine to provide essential servicing platforms. A number of Austrian financial institutions have already completed successful NPL transactions in 2016 with more in the pipeline.

Ukraine has ongoing financial sector reforms slated for 2016 through 2020 and intrepid NPL investors may indeed find an investment hidden gem in Ukraine. DLA Piper will continue to monitor the CEE and SEE NPL market and advise you of legal developments and commercial opportunities.

# NEW AUSTRALIAN PROPERTY TAXES ADD TO COSTS OF FOREIGN PURCHASERS OF RESIDENTIAL REAL ESTATE

PETER FALUDI AND EDDIE AHN, SYDNEY

In a recent article on Australia's foreign investment regime (see Peter Faludi and Bhavini Sudarjee, "Australia's foreign investment regime reloaded" *Real Estate Gazette* (Issue 24) page 36 ff (print) and page 62 ff (z-mag)), it was noted that included in the amendments made to the Foreign Acquisition and Takeovers Act (FATA) from 1 December 2015, application fees apply to foreign investment proposals, including those relating to acquisitions of interests in Australian real estate (including off the plan purchases of residential property).

Each of the Eastern Seaboard States of Australia (being Queensland, New South Wales and Victoria) have now introduced additional duties payable by foreign residents acquiring residential real estate in those states. These duties are in addition to the normal transfer duties payable on the acquisition of real estate in each jurisdiction. Although Victoria has had such a regime since 1 July 2015, it has recently increased the rate of such duty from 3 per cent to 7 per cent.

The purpose of this article is to outline the additional duties that are now payable in those Australian states by foreign purchasers of residential real estate. As will be seen, the application of these duties is not limited to purchases by individuals and in some states extends to property which would not normally be regarded as residential land for other purposes.

## New South Wales

### Surcharge purchaser duty

Transfer duty is imposed on the dutiable value of real estate (whether residential or otherwise) in New South Wales (NSW). Such duty has always applied and is calculated on an ad valorem basis. For properties valued between \$300,000 and \$1 million, the duty is \$8,990 plus

\$4.50 for every \$100 that the value exceeds \$300,000. For properties with a value of over \$1 million, the duty is \$40,490 plus \$5.50 for every \$100 that the value exceeds \$1 million. In relation to residential property, if the value of the property is over \$3 million, the duty payable is \$150,490 plus \$7 for every \$100 that the value exceeds \$3 million.

As from 21 June 2016, in addition to the above duties, if the purchaser is a foreign person and the property being acquired is residential related property, an additional surcharge of 4 per cent of the dutiable value of the property (inclusive of surcharge purchaser duty (GST)) is to be paid by the purchaser.

Residential related property is defined as being:

- residential land in NSW;
- an option to purchase residential land in NSW;
- an interest in any residential land in NSW or option to purchase such land except to the extent that:
  - it arises of the consequence of the ownership of a unit in a unit trust scheme and is not a land use entitlement;
  - it is, or is attributable to, an option over residential related property;
  - it is a marketable security;
- a partnership interest (being an interest in a partnership that has partnership properties that is residential property).

Residential land is not limited to land on which there are one or more dwellings but also extends to:

- a parcel of land on which there is a building under construction, that when completed will constitute one or more dwellings;

- a strata lot, if it is lawfully occupied as a separate dwelling or suitable for lawful occupation as a separate dwelling; and
- vacant land (including any land that the Chief Commissioner is satisfied is substantially vacant) that is zoned or is otherwise designated for use under an environmental planning instrument principally for residential purposes.

The acquisition of any of the above types of residential related property by a foreign person will be subject to the 4 per cent surcharge purchaser duty. As is made clear above, this will extend not only to acquisitions of property that the purchaser intends to inhabit or to rent out, but will extend to developers wishing to develop residential land or vacant land zoned principally for residential purposes.

If the acquisition by a foreign person of the interest in residential related property is through a unit trust or company, to the extent that the foreign person holds an interest of more than 20 per cent (or a number of foreign persons together with any one or more associates hold at least 40 per cent) of the trust or company, the surcharge purchaser duty will be payable by reference to the percentage ownership interest in the trust or company held by the foreign persons. The surcharge purchaser duty is calculated by reference to the proportion of the total value of assets held by the trust or company which comprises residential related property.

Purchasers buying residential property off the plan previously had 12 months from the date of contract in which to pay the relevant stamp duty. These rules have also changed so that in the case of foreign persons, both the stamp duty and the surcharge purchaser duty must now be paid within three months after



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The NSW Office of State Revenue has issued a useful guide to the surcharge purchaser duty regime which explains the broad impact of the changes.

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entering into the contract.

Particular issues arise if the purchaser is a trustee of a discretionary trust. Although such a trustee has a discretion as to which beneficiaries are entitled to income and property of the trust, if any of the potential beneficiaries is a foreign person, the trustee will be liable to pay the surcharge purchaser duty.

In determining whether or not a corporation or trust is a foreign person, the tests to be satisfied are similar to those that apply under the FATA.

The New South Wales Office of State Revenue has issued a useful guide to the surcharge purchaser duty regime which explains the broad impact of the changes on foreign persons buying residential property (either to live in, to rent out or to develop).

If a foreign person wants to acquire a commercial building in NSW, there would be no surcharge purchaser duty applicable (even if subsequent to acquisition, the purchaser intends to seek a change in the zoning classification and demolish the building to develop residential premises).

The surcharge purchaser duty also applies to indirect acquisitions of NSW residential real estate by foreign persons that are subject to landholder duty. Broadly speaking, landholder duty is levied at transfer duty rates on acquisitions of a majority interest (ie 50 per cent or more) in companies or trusts that own real estate in NSW valued at over \$2 million. If the relevant company owns residential land at the time of acquisition of the interests by the foreign person, the surcharge purchaser duty will apply.

#### **Land tax surcharge**

In addition to imposing the surcharge purchaser duty, as from midnight on 31 December 2016, an additional land tax



surcharge will apply to any residential land owned by a foreign person as at that time and in any subsequent land tax year. The additional land tax payable is 0.75 per cent of the taxable value of the land (as calculated in accordance with the existing land tax rules). Although a minimum threshold applies in relation to the imposition of land tax (such that if the taxable value is less than \$400,000 no land tax is payable) this threshold does not apply in relation to the land tax surcharge which is payable irrespective of the taxable value of the property. In addition, even if an exemption would apply in relation to the payment land tax, this will not apply to the payment of the land tax surcharge which would remain payable.

### Victoria

As mentioned above, Victoria has imposed a foreign purchaser additional duty (FPAD) in relation to the acquisition of residential real estate as from 1 July 2015. The initial rate of this additional duty was 3 per cent of the dutiable value of the purchased property (inclusive of GST).

From 1 July this year, that rate has increased to 7 per cent. As in NSW, this duty is payable in addition to the existing land transfer duties payable on acquisitions of real estate in Victoria (and is calculated at different rates than those applicable in NSW).

The type of residential land to which the FPAD applies is broader in Victoria than in NSW. In NSW, the land needs to be classified as residential in order to attract the additional duty. In Victoria, the residential property to which the additional duty applies extends to:

- land capable of being used solely or primarily for residential purposes and that may be lawfully used in that way;
- land which includes a building, or part of a building, that a person intends to refurbish or extend so the land is capable of being used solely or primarily for residential purposes and that may be lawfully used in that way;
- land:

- on which a person intends to construct a building so the land is capable of being used solely or primarily for residential purposes and may be lawfully used in that way; or
- in respect of which a person has undertaken or intends to undertake a land development for the purposes of:
  - (a) constructing a building so the land is capable of being used solely or primarily for residential purposes and may be lawfully used in that way; or
  - (b) enabling another person to construct a building so the land is capable of being used solely or primarily for residential purposes and may be lawfully used in that way.

By including the qualification "and may be lawfully used in that way", there seems to be a requirement that the appropriate zoning applies to the building although the point of time at which such zoning should apply is unclear.

The criteria includes circumstances where a person "intends" to do something. It appears that the FPAD will apply even if at the time of entering into a contract the purchaser did not intend to develop the property primarily for residential purposes. The Victorian State Revenue Office has indicated that even if a foreign person acquires non residential property, if the purchaser subsequently decides to convert that property into residential property it must notify the State Revenue Office in writing within 14 days of forming that intention and must pay the additional duty within 30 days of forming the intention. There is no time limit after which the obligation lapses. This raises uncertainty as to the correct amount of duty payable where a change of intention occurs many months after the initial acquisition.

In order for a corporation or trust to be regarded as a foreign person for the purposes of the Victorian duty changes, different tests apply to those in NSW. In the case of a company, this requires a foreign natural person, another foreign



corporation or a trustee of a foreign trust to have a controlling interest in the company. Essentially this is where the foreign person is in a position to control more than 50 per cent of the votes of the shareholders or has more than 50 per cent of the issued shares in the corporation. It can also apply in other circumstances where the Commissioner of State Revenue is of the opinion that the foreign person is able to influence the outcome of decisions about the company's operating policies. These are essentially the Corporations Act criteria for control. In the case of a foreign trust, this requires a foreign natural person, a foreign corporation or a foreign trust to have a beneficial interest of more than 50 per cent in the capital of the

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The recent uncertainty created by Brexit as well as other global factors is likely only to enhance the attractiveness of Australia as an investment destination for foreign capital.

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trust or, in the Commissioner's opinion, to have the capacity to determine or influence the outcome of decisions about the administration and conduct of the trust. Given the operation of these tests, a trust or a company which is not majority foreign owned will generally not be regarded as a foreign person for the purposes of these additional provisions.

As with NSW, the FPAD also applies to indirect acquisitions of Victorian residential real estate by foreign persons that are subject to landholder duty.

An exemption from the FPAD is available for acquisitions by developers provided that certain requirements are met. In particular, the Commissioner needs to be satisfied that the

development will substantially add to the supply of housing stock in Victoria. Exemption applications need to be filed before completion of the purchase.

It is clear that in Victoria, the acquisition of a commercial building (at a time when the foreign purchaser did not intend to convert it to residential use) would not initially be subject to the FPAD. However, if there was a change in the intention of the purchaser as to the use of the property (so that it intended to convert the property into residential premises), the FPAD would be payable.

As from 1 January 2017, it is expected that the existing land tax surcharge of 0.5 per cent will increase to 1.5 per cent.

The Victorian land tax surcharge will apply as from 31 December 2016 (similar to that in NSW). However, unlike NSW, it will apply to all land subject to land tax in Victoria not just residential land.

### Queensland

As from 1 October 2016, Queensland will also impose a foreign purchaser surcharge duty at the rate of 3 per cent on acquisitions of residential land by foreign persons, which is in addition to the existing land transfer duties payable in Queensland on acquisitions of real estate (and which are calculated at different rates to those applicable in NSW).

Residential land means land that is or will be solely or primarily used for residential purposes and on the land:

- there is or will be a building designed or approved by a council as a single family residence;
- there is or will be a number of lots in a strata title building; or
- an existing building will be renovated to be a house or apartment complex; or
- the land is development land in respect of any of the above.

It is clear then that the meaning of residential land in Queensland is even broader than that in Victoria and will potentially catch any transaction involving the acquisition of land (whether or not

then currently zoned residential) on which there is or will be a building in which a number of lots in a strata title building will be created/developed.

The test as to when a foreign corporation or trust is to be regarded as a foreign person for the surcharge duty provisions is similar to that in Victoria. Similar issues apply in relation to discretionary trusts as mentioned above for NSW.

As with NSW and Victoria, the surcharge duty also applies to indirect acquisitions of Queensland residential real estate by foreign persons that are subject to landholder duty.

The Queensland Government has indicated that an exemption may be provided for developers, in certain circumstances, but details of the proposed exemption have not yet been released.

There is currently no intention to introduce a land tax surcharge for foreign owners of residential property in Queensland.

### Conclusion

Australia continues to be a preferred destination for foreign capital in relation to real estate investment. The recent uncertainty created by Brexit as well as other global factors is likely only to enhance the attractiveness of Australia as an investment destination for foreign capital.

Nonetheless, investors considering acquiring or developing residential property in Australia will need to be aware of the additional costs which have now been imposed on purchasers under both the FATA and the stamp duties legislation of the States of Queensland, NSW and Victoria. Although the author is not aware of similar intentions by other state governments, they may very well follow suit.

If you would like any further information as to the various taxes and duties imposed on foreign persons acquiring real estate in Australia, please do not hesitate to contact one of DLA Piper's Real Estate or Tax Teams.

# NEW RESTRICTIONS FOR PENSION FUNDS INVESTING IN REAL ESTATE IN ITALY

AGOSTINO PAPA, NICOLETTA ALFANO  
AND LICIA MONGIELLO, ROME



**P**ension funds (PFs) in Italy are regulated by the Ministerial Decree No. 166 of 2 September 2014 (the PF Decree). This implements Article 6 of the Legislative Decree No. 252 of 5 December 2005 on (i) investment criteria and investment limits; and (ii) conflicts of interest in relation to pension funds.

The implementing regulation of the Legislative Decree for private social security associations (PSSAs) has not yet been issued, but the public consultation period on a new ministerial decree (referred to as the Envisaged Decree) ended on December 2014, and on 3 August 2016 a new draft of the Envisaged Decree was announced.

This article outlines the main points of the PF Decree and discusses the possible rules that will most likely be provided for by the Envisaged Decree regulating PSSAs.

## Legal framework applicable to pension funds

The PF Decree lays down rules on (i) management criteria and administrative and procedural structures; (ii) permitted investments and transactions; (iii)

investment limits; and (iv) how to manage potential conflicts of interest.

### Management, investment criteria and investment policy document

In carrying out its activities, a PF must ensure it is managed prudently and that it acts in the interest of its members. The investment strategies pursued must be consistent with the risk profile of the PF with the aim of preserving the financial stability and liquidity of the investments made.

In order to enhance the portfolio's risk-return profile, a PF must ensure its portfolio is suitably diverse for the purpose of limiting risk and its reliance on management performance. Moreover, to maintain management efficiency and the best results for its members, a PF must keep transaction, management and running costs as low as possible, and structure its administrative and technical functions in a way that best matches the size, complexity and/or characteristics of the portfolio owned. All such entities are subject to the control of the Italian Supervisory Commission on Pension Funds (*Commissione di Vigilanza sui fondi*

*pensione*, referred to here as COVIP).

In terms of the Legislative Decree, a PF is entitled to manage its own funds directly or indirectly. Indirect management is carried out through agreements between the PF and, among others, insurance companies, asset management companies or any other managers of the Italian or EU Undertakings for Collective Investment (UCIs).

In terms of the PF Decree, a PF must send COVIP documentation defining its investment policy and investment procedures, and describing its administrative, professional and technical structure. Any amendment to such matters must be notified promptly to COVIP.

### Permitted transactions and investment limits

Under the PF Decree, a PF may not lend or borrow money, or issue guarantees but it may, amongst other things, enter into repurchase transactions, hold liquidities or invest in derivative instruments.

Although there are some instances in which COVIP may allow a PF to exceed the investment limits laid down, nonetheless, the PF Decree does impose

certain limits on investments made by a PF.

A PF is entitled to invest mainly in financial instruments traded on regulated markets and the investments in financial instruments outwith a regulated market must constitute less than 30 per cent of the assets of the PF. Re derivative instruments, the limits imposed on the PF's investments in financial instruments is generally 5 per cent of the PF's available assets in case of instruments issued by one issuer, and 10 per cent of the PF's available assets in case of assets issued by issuers belonging to the same group and where the investments in derivative instruments can be made to hedge the risk.

These limits do not apply when a PF invests in UCIs, including Alternative Investment Funds (AIFs), and EU or non-EU AIFs authorized to be marketed in Italy.

In relation to these investments, a PF is allowed to invest provided that:

- (a) the investment is adequately justified by the PF itself in accordance with its own size and investment characteristics and following efficiency and effectiveness principles;
- (b) the UCIs' investment policy is compatible with PF's investment policy;
- (c) the investment does not cause unacceptable risk;
- (d) the PF is able to monitor the risk related to each UCI;
- (e) the investment does not involve additional charges;
- (f) without prejudice to the principle of adequate diversification of investments, the investment in the AIF (made within the overall limit of 20 per cent of the available assets of the PF) does not exceed 25 per cent of the value of the AIF; and
- (g) where the investment refers to non-EU AIFs not marketed in Italy, cooperation agreements between the competent authorities of the home country and the Italian authorities exist.

The investments of a PF in financial instruments relating to commodities must not exceed the 5 per cent limit, the counterparties must be creditworthy and their financial position must be secure. With respect to the currency exposure, which must be in compliance with the investment policies of the PF, this must not exceed 30 per cent of the total assets owned by the PF.

It is worth highlighting that investment in closed-ended funds, made through asset management mandates, is not subject to the abovementioned limits.

#### Conflicts of interest

A PF must adopt a procedure to identify

and manage conflicts of interest (if the PF has a separate legal personality), or by the company or the body into which the PF is incorporated (if the PF does not have its own legal personality). If the PF is a separate legal person, Article 2391 of the Italian Civil Code, setting out the rules relating to conflicts of interest, will apply to the administrative body and to each member of the board.

#### Incompatibility

It should be noted that the office of carrying out administrative, managerial or control functions for a PF is incompatible with the office of carrying out administrative, managerial or control functions for the manager, the depositary or for any other company belonging to the group of the depositary or of the manager.

#### The Envisaged Decree

The Envisaged Decree follows a similar framework to that of the PF Decree and contains similar rules to regulate PSSAs.

#### Management, investment criteria and investment policy document

PSSAs, like PFs, must be subject to sound and prudent management and, in carrying out their activity, must act in the best interests of their members and beneficiaries. PSSAs can invest directly or indirectly.

In terms of the Envisaged Decree, PSSAs must choose their managers following a selection process based on transparency and competitiveness. The Envisaged Decree states that the management agreement entered into by PSSAs must: (i) lay down the guidelines of the activity to be performed; (ii) provide for the right to terminate the agreement itself; and (iii) entitle the PSSAs to exercise voting rights relating to the security owned. These requirements mean that PSSAs are required to monitor, including through asset management companies to which mandates have been given, all investments made, both directly and indirectly, in order to guarantee compliance with the investment criteria and objectives.

PSSAs are subject to more onerous reporting duties than PFs. The Envisaged Decree provides that PSSAs are required to provide a document outlining its investment policy, including its investment objectives and criteria, asset allocation strategies, risk parameters, and the methods employed in monitoring, managing and controlling risk. This document must be revised at least every three years and notified, within 20 days of approval, to the relevant monitoring ministries and to COVIP. Additionally, PSSAs must submit a prospectus listing the assets owned and any liabilities incurred. This prospectus is sent to the

monitoring ministries and to COVIP, and is also published on the PSSA's website.

#### Permitted transactions and investment limits

Some of the investment limits described above for PFs are slightly different in the case of PSSAs' investments.

According to recent announcements concerning the forthcoming Envisaged Decree, it seems that PSSAs investing in AIFs will be subject to a "double 10 per cent rule": in fact, PSSAs would not be able to make investments exceeding one-tenth of their assets and the investment in a single AIF must not exceed 10 per cent of the value of the AIF.

Moreover, in order to manage risk prudently and for the purpose of asset diversification, a further maximum ceiling of 20 per cent for investments in real estate assets and in real estate rights appears to be provided for by the Envisaged Decree for PSSAs.

While the investment limits are stricter, however, the range of permitted transactions for PSSAs, is wider than that permitted for PFs. The Envisaged Decree provides for the possibility, subject to certain conditions (ie only if strictly connected with its activity, for liquidity purpose or for purposes strictly related to the investment activity performed), for PSSAs to lend, borrow, and to issue guarantees in favour of third parties.

#### Conflicts of interest

In relation to managing conflicts of interest, the difference between an entity with or without a legal personality does not apply in terms of the Envisaged Decree. However, periodic reporting to the relevant ministries and to COVIP regarding conflicts of interest procedures has been introduced.

#### Depositary

A new provision of the Envisaged Decree states that PSSAs shall select depositaries using a selection process based on transparency and competitiveness criteria. An EU entity authorized under the EU directives (1993/22 or 200/12 or 6299/65) can also be appointed.

#### Transitional period

The most recent consultation draft stated that the Envisaged Decree is to come into force on the first date between 1 January and 1 July following the publication of the Envisaged Decree. An 18-month interim period (starting from the effective date) will be provided for the PSSAs to comply with the Decree (with respect to new investments, administrative and procedural duties, etc). With respect to existing real estate assets exceeding the new investment thresholds, the PSSAs have five years in which to reduce their exposure and comply with the new applicable limits.

# NEW FRAMEWORK FOR ARBITRATION IN RUSSIA

MARIA GORLENKO, MOSCOW

**N**ew legislation governing arbitration institutions and procedures came into force on 1 September 2016. This article highlights the differences between state courts and arbitration institutions in Russia, explains why reform was necessary, and the advantages of the changes introduced by the legislation.

## State courts and the background of arbitration

It is generally accepted that the state court system in Russia is complex, overloaded, opaque and ineffective. The court system is split into two subdivisions: courts of general jurisdiction, and *arbitrazh* (commercial) courts, which are competent to hear all commercial and business disputes.

The commercial courts are structured in a hierarchy, namely the court of first instance, the court of appeal, the cassation and "second cassation" within the Supreme Court (although extraordinary appeals may also be heard by the Supreme Court) and each case may take anything from six months up to three years to make its way through these courts. It is standard practice in large parts of Russia for a single judge to hear between 20 and 35 cases per day, and in many cases, the huge judicial workload will mean that judges have neither the time nor the expertise to give each matter the attention it deserves.

Since 1992 the Law on International Commercial Arbitration has governed the arbitration of international commercial disputes. Domestic arbitration was governed by a number of different statutes until the Federal Law on Arbitration Courts in the Russian

Federation was passed in 2002.

However, poor drafting of the law on domestic arbitration meant that a large number of small and negligent arbitration institutions were able to operate. For example, some arbitration institutions misled parties into believing that they were state courts by using state symbols and names similar to state courts (such as the Moscow Arbitration Court, Higher Arbitration Court, etc). Other arbitration institutions were established by large corporations with the sole aim of hearing disputes between themselves and their contractors (known as "corporate" or "pocket" arbitration institutions).

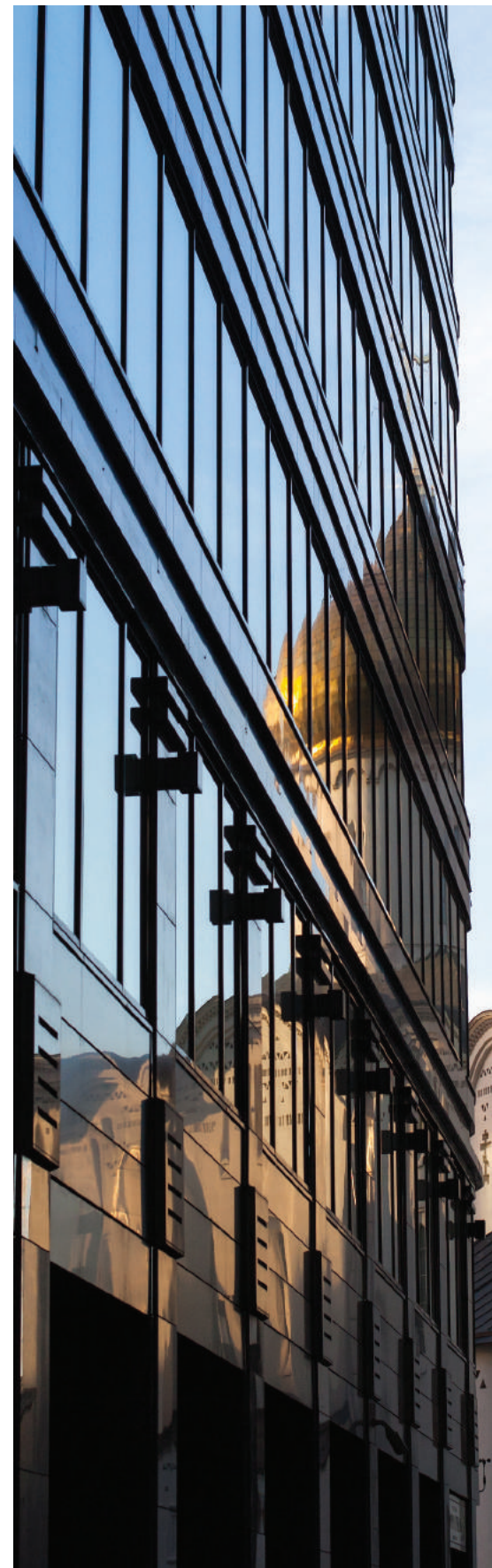
These unsatisfactory practices have led to a lack of trust in arbitration in Russia, causing foreign investors to prefer foreign arbitration institutions as venues for dispute resolution.

## New legislation

The new law introduces significant changes to the way the arbitration procedure is regulated and to the manner of establishing and running arbitration institutions in Russia. These changes are aimed at promoting new and independent arbitration institutions as well as encouraging those institutions that are already established to provide impartial and efficient arbitration services.

The main innovations of the new law include the following:

- provision of a comprehensive list of disputes that are not suitable for arbitration;
- the possibility for most corporate disputes to be arbitrated (from 1 February 2017, this will be subject to several conditions);
- authorization of state courts to assist





and supervise arbitration tribunals during the arbitration proceedings (previously there was no such supervision—the law governed only the enforcement and appeals procedures);

- provision of strict regulation on the establishment of arbitration institutions. For example, these can only be set up as subdivisions of non-commercial bodies and they must obtain express authorization to act as an arbitration institution from the Russian Government, based on a recommendation from the Council on the Development of Arbitration which is to be established by the Russian Ministry of Justice;
- a prohibition on some non-commercial bodies (such as government bodies) acting as arbitration institutions;
- a requirement that the recommended list of arbitrators of arbitration institutions must include at least 30 persons, a third of whom must hold a Russian academic degree and half of whom must have a minimum of 10 years' professional experience as arbitrators or as judges (retired judges are now allowed to act as arbitrators). The same person cannot be included in the list of arbitrators of more than three different arbitration institutions.

The new legislation has many advantages which should encourage businesses to use arbitration rather than the courts as a means of resolving disputes. These include:

- the high professional standards required of arbitrators;
- the possibility of selecting an arbitrator who is a specialist in a particular area (such as insurance, oil and gas, etc);
- the increased time an arbitrator should have to focus on each individual case;
- the fact that there is only one opportunity for the dispute to be heard on its merits; and
- the confidentiality afforded by arbitration.

Foreign arbitration institutions may also be granted the status of an arbitration institution in Russia provided they obtain the relevant permission from the Russian Government. This is subject to only one condition: the foreign arbitration institution must have a widely acknowledged international reputation.

## Disputes over rights to land

It was previously unclear whether disputes related to immovable property, especially in relation to title, could be resolved by arbitration institutions. However the Constitutional Court of the Russian Federation in 2011 stated, and the new law confirms, that disputes over immovable property may be resolved by arbitral tribunals. However under the new law, a decision by an arbitral tribunal does not on its own entitle a party to register ownership; it needs to be supported by a writ of execution issued by a state court.

## The future

From 1 September 2016 new arbitration institutions may only be established in compliance with the new legislation. Furthermore, all existing arbitration institutions must either comply with the new legislation and be authorized to act as such no later than one year after 1 November 2016, or they must cease their activity. In other words, unauthorized arbitration institutions will not be able to operate after 1 November 2017.

The International Commercial Arbitration Court and the Maritime Arbitration Commission of the Russian Chamber of Commerce and Industry are exceptions to this rule and do not require government authorization to continue their operations, but they do still have to comply with the provisions stipulated in the new law.

It is expected that the new law will help to reduce the volume of arbitration institutions operating to a small number of reputable, diligent and independent arbitration institutions.

It seems likely that arbitration institutions will continue to be developed in Russia not only as an alternative to state courts, but also as an alternative to foreign arbitration institutions. These have been commonly used by Russian businesses, but they are becoming increasingly inaccessible due to their escalating cost as a result of the instability of the rouble exchange rate. In conclusion, the changes outlined in this article look set to enhance Russia's attractiveness as a forum for arbitration.

# THE EFFECT OF BREXIT ON OPEN-ENDED COMMERCIAL PROPERTY INVESTMENT FUNDS

KAREN HALSEY, LONDON

**W**e are all aware of the speculation surrounding the effects of “Brexit” on the property market and the British economy as a whole. Some are suggesting that we will enter into recession, if not next year, in the next few years, whilst others are more positive and consider that retention of the single market has been secured and that activity in the real estate markets will return to normal levels. Only one thing is certain—no one really knows quite what will happen next.

Over the last few weeks we have seen a number of open-ended commercial property investment funds—that is, funds that use investors’ money collectively to acquire assets—close those funds. Standard Life Investments UK Real Estate Fund (and associated funds) led the way when it suspended trading at midday on Monday 4 July. This is thought to be the first UK property fund to take such steps since the end of the financial crisis in 2009. They were closely followed by M&G Investments and Aviva UK Property Trust, both closing their funds on 5 July, and Columbia Threadneedle, Henderson Global Investors

and Canada Life on 6 July. These funds collectively hold approximately £15 billion of property in total.

Before taking the decision to close their funds, a number initially reduced the value of their funds by between 3 and 5 per cent, perhaps in an attempt to make the prospect of leaving a fund less attractive, but at the same time spooking a number of investors into leaving the funds.

Funds being closed, or locked, prevents investors from withdrawing their money. In the wake of the EU referendum, an increase in the number of redemptions being requested was noted due to the insecurity felt by many as to where the market would go. This caused funds to become concerned that the level of cash they held to meet such requests would quickly be called into question.

An increasing number of requests places pressure on the liquidity of funds. Whilst they do hold some other assets and cash reserves, they are predominantly illiquid given the nature of their main focus, real estate. In such times there is a risk that assets will need to be disposed of quickly in order to meet the redemptions being made. Therefore a number of the funds

ceased trading in order to prevent there becoming an increasing need for “fire sales”, that is, quick sales at prices below market value and to prevent the market from being flooded with property against market norm. These may in turn have a negative effect on property values, a sharp drop in value being one of the factors that investors were looking to avoid by exiting funds in the first place! A self-fulfilling prophecy perhaps? Many of us will recall the run on banks, such as Northern Rock, being blamed as the cause for the bank’s collapse back in the financial crisis.

It is the intention of the funds to provide themselves with breathing space, a period without immediate pressure when the required disposals can be achieved at reasonable values. Henderson described its suspension as allowing for “an orderly sale of some properties”. But how long these funds will remain closed is unclear. M&G have said they will review the suspension every 28 days, whilst others are undertaking reviews weekly in order to keep on top of the moving, potentially volatile, market.

In addition to driving down values, some see the pressures on funds as having an effect on commercial lending. The Financial







Policy Committee of the Bank of England in its half yearly report stated: "Open ended funds could be forced to sell illiquid assets to meet redemptions if conditions persist beyond funds notice periods. Any such amplification of market adjustments could affect economic activity by reducing the ability of companies that use commercial real estate as collateral to access finance."

Steps to prevent investors having access to their money go against the open and flexible nature of these funds. An interesting point to be explored is whether a number of investors could collectively force closure of a fund and require the disposal of assets in order to release their money, albeit that it may be at a reduced pence in the pound. If the time that these funds remain closed is extended too far we may see some challenges to such closures by their customers.

Of course the million-dollar question is whether the closure of open-ended funds is an indication that we are heading for another financial crisis. Whilst the last time funds of this nature suspended trading was in the financial crisis of 2007–09, the majority of analysts anticipate that there will be a continued downturn in the market until there is some certainty as to

where we lie in the EU, but *not* a financial crisis. It is a widely held view that since the banks are better capitalized today, a drop in valuations would not have the same impact as it did in the financial crisis.

It is worth noting too that not all funds have ceased trading. Instead they prepared for the rush of redemptions by increasing their cash holding ahead of the Brexit vote. Legal & General, Kames Capita and (initially) Aberdeen Asset Management stated that they had increased their liquidity in anticipation of the vote and were therefore well placed to "deal with the current market".

Whilst Aberdeen Asset Management did subsequently close, it has now reopened its property fund, imposing a markdown of 26 per cent, which comprises 18 per cent as a "quick sale" price adjustment, together with a 1 per cent sales cost and 7 per cent "fair value" reduction. This has been viewed as an unusual strategy but one that is positive. Adrian Benedict (Head of Real Estate at asset management firm, Fidelity International) said recently: "What they're trying to say here is quite positive—like other asset classes we have volatility, and if you want to come out here

is the price. They are trying to honour the commitment to daily liquidity. Those who've suspended have erred on the side of caution and they will hope volatility across the market will ease."

A further positive step has been made by Legal & General recently reducing what they described as a "fair value adjustment" from 15 per cent to 10 per cent as they see that "conditions in the market and within our peer group have begun to stabilise".

And perhaps we should be positive that the reduction in assets on to the market will have the effect that is sought, namely, sustaining asset values. As John Cartwright, Chief Executive of the Association of Real Estate Funds commented: "When it comes to disposals there's not a great deal in the market at the moment so I wouldn't be surprised if values remain strong."

Let's hope that his optimistic view is held by many so that values are maintained and economic activity returns to more usual levels. However, perhaps investigating the ways in which investors could force closure of open-ended funds would be time well spent.



# THE CURRENT LEGAL ENVIRONMENT FOR INVESTMENT IN UKRAINIAN REAL ESTATE

NATALIA KOCHERGINA, KIEV

**L**ocated in the heart of Europe and with a population of over 40 million, Ukraine remains an attractive and unsaturated market, offering the potential for rewards which outweigh the challenges. Although the current difficulties have put significant pressure on the Ukrainian economy, there are sectors and businesses within the country which are investment-attractive and offer a considerable level of profitability, including agriculture, manufacturing and infrastructure.

Implementation of the EU Association Agreement on 16 September 2014 requires Ukraine to implement a number of institutional reforms, including trade, economic integration and reform of government bodies, and to gradually bring Ukraine's legislation into line with EU standards within timelines varying between two and ten years after the Agreement comes into force.

In recent years, the legislative environment for conducting real estate business in Ukraine has substantially improved. According to the World Bank's "Doing Business 2016" report, Ukraine climbed to the 83rd position out of 189 economies, demonstrating sustained improvement of business conditions for several years in a row.

State and local authorities are being restructured and devolved to make their operations more effective and business-oriented. Anti-bribery procedures are also being actively applied to decrease the level of corruption.

On the corporate side, the rules for establishing, administering and dissolving companies have been further simplified by shortening the terms for registration/dissolution, abolishing certain registration charges, and eliminating the requirement to have a formal charter. As a result, it now takes only two business days to register a limited liability company,

compared to the two weeks required under the previous procedures. Registration activities may also be performed by notaries on the basis of the ex-territoriality principle.

Significant steps are being taken to make the legal framework for registering titles to real estate and land more investor-friendly and secure. One major change which took effect on 1 January 2015, is that all information about registered titles, including information about title holders and encumbrances affecting the land, has been made open to the public electronically (previously such information was available to title holders only). Public access to information is also currently being implemented with regard to the land- and town-planning cadastres. As a result, title checks and registration of titles/encumbrances over real property have become significantly more efficient and less bureaucratic. The system of registration and



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The public–private partnership (PPP) sector has become an attractive area for foreign industrial investors in Ukraine.

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registration procedures has been further improved this year, with responsibility for it being transferred to local government.

The planning and construction sectors have also seen significant developments. Regulation of these sectors has been generally transferred from state to local government, and planning and construction permitting procedures have been simplified and shortened. The procedure for obtaining title to state and municipal land for construction and other purposes is now based on the “one-stop-shop” principle.

On the financing and tax side, real estate investments are traditionally structured via the Cyprus Treaty approach (the new protocol to the bilateral double tax treaty was signed on 2 July 2015, to become effective from 2019). Although still applicable, currency restrictions are also being relaxed by the National Bank of Ukraine (particularly the requirements for mandatory conversion

of foreign currency and the restrictions concerning registration of loans with non-residents, both of which have recently been relaxed).

As a result of the Law on Sea Ports coming into effect in 2013, the public–private partnership (PPP) sector has become an attractive area for foreign industrial investors in Ukraine. While the Ukrainian Government still has work to do on certain detailed regulations, the reforms already carried out in the sector have enabled investors to acquire rights to operate commercial port facilities (ie terminals) based on concession or lease agreements and to construct and fully own major port facilities, including sea terminals such as shipping berths. Of course, the state retains ownership of certain strategic port facilities such as navigation facilities, waterfronts, etc. For more on this, see Sergiy Pomoy, “New legislation on concession of seaports in Ukraine” *Real*

*Estate Gazette* (Issue 17, 2014) page 34 ff (print) and page 56 ff (z-mag).

At the same time, foreigners may only lease and not own agricultural land. In addition, the Ukrainian parliament has extended the land moratorium (prohibiting individuals from selling privately owned agricultural land) until the end of 2016.

Although Ukraine still suffers from corruption, weak judicial and law enforcement systems, and an unstable political situation, a review of the ongoing legislative initiatives points to further simplification of land allocation, planning, construction, and permitting procedures for real estate business, as well as a general improvement of conditions for those dealing in real estate in Ukraine, in accordance with EU and international practices.

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# IMPACT OF RECOVERY GAP ON UPCOMING LOAN MATURITIES

BRUCE GAMBLE\* AND RICK CHESLEY, CHICAGO

**S**even years after the official end to the Great Recession, the disparity in the real estate market recovery between the major markets, including New York City, Washington, DC, Boston, Chicago, Los Angeles and San Francisco, and all other markets continues to persist. While the majority of commercial real estate asset values in major markets have surpassed their 2007 peak levels, real estate assets outside of major markets and within certain asset classes (eg retail and suburban office space) still remain below the pre-recession peak. Additionally, although office properties located in commercial business districts (CBD) outside of major markets have recovered the value lost during the recession, the recovery levels remain less than those experienced by CBD office properties in the major markets. The difference in recovery levels between major markets and all other markets for CBD office and retail continues to grow, increasing approximately 30 per cent over the past year.

A further illustration of inconsistent recovery in specific major markets such as Manhattan, San Francisco and Los Angeles as compared to secondary markets such as Atlanta, Phoenix and Las Vegas may be seen through a comparison of commercial real estate property prices (office, retail and industrial).

## **Suburban office obsolescence**

The recovery gap between CBD and suburban markets is likely to continue to increase as suburban office properties experience greater levels of obsolescence. A study completed by Newmark Grubb Knight Frank in late 2015 evaluated six quantifiable factors related to commercial office buildings

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The recovery gap between commercial business districts and suburban markets is likely to continue to increase.”





including location, building size, floor plate size, parking, amenities and building age. The study revealed that a significant share of suburban office inventory is obsolete by today's standards. Owners and managers are faced with the challenge of determining whether the obsolescence is curable through capital investment or if the building is beyond such repairs and needs to be repurposed or demolished.

### **Refinancing overleveraged loans**

Many properties were financed with 10-year loans during the peak of the market (ie 2006–07) and face imminent refinancing pressure. Because real estate assets may continue to have values that have not recovered to pre-recession levels and given underwriting standards at the peak of the market, many of these loans remain overleveraged and will face difficulty refinancing without an equity infusion. Morningstar estimates that 47 per cent of the \$30 billion in CMBS loans maturing in the second half of 2016 have loan-to-value ratios (LTVs) in excess of 80 per cent, and 43 per cent of the \$98 billion in CMBS loans maturing in 2017 have LTVs in excess of 80 per cent.

The loans at greatest risk are those secured by retail collateral. For example, retail loans comprised over 30 per cent of the maturing loans liquidated from January to July 2016 and approximately 55 per cent of the outstanding balance was lost as compared to the year-to-date average loss severity of less than 44 per cent for all loans liquidated. CMBS with exposure to retail loans will continue to be of concern given the recent wave of store closures by Macy's, Ralph Lauren, Aeropostale and

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During 2015, commercial bank exposure to commercial real estate loans increased by over 10 per cent.

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Sears, to name a few. Additionally, the bankruptcy of Sports Authority resulted in the closure of all 460 of its stores. The impact is anticipated to be greatest on those malls where Sports Authority and/or a closed Macy's store served as the anchor tenant. Based on Morningstar analysis, \$28.5 billion in loans securitized through CMBS transactions include Macy's as a collateral tenant or anchor.

Delinquency rates on CMBS loans have been pushed higher by the declining payoff rate for maturing loans combined with decreases in the overall balance of outstanding CMBS. After a strong year in 2015, with domestic CMBS issuances exceeding \$100 billion for the first time since 2007, volume was less than \$32 billion in the first half of 2016, representing a 45 per cent decline as compared to the first half of 2015. Coupled with the impact of maturing loans, the balance of CMBS outstanding declined approximately 6 per cent to \$504 billion in the first quarter of 2016 as compared to \$534 billion in the first quarter of 2015.

### Declining share of lending provided by CMBS

For the first half of 2016, CMBS issuance comprised only 7 per cent of the overall CRE lending volume, down from 17 per cent in 2015 and nearly 50 per cent in 2006, as reported by the CRE Finance Council at its June 2016 meeting. As CMBS lenders pulled back, banks and insurance companies became more active. Banks are the largest source of commercial mortgage debt, holding approximately 39 per cent of mortgage

debt outstanding as of the end of the first quarter 2016. Banks increased their holdings of commercial and multifamily mortgage debt by 12 per cent as of the end of the first quarter 2016 as compared to the first quarter 2015.

During 2015, commercial bank exposure to commercial real estate loans increased by over 10 per cent. Accelerated growth did not escape the attention of banking regulators and in December 2015, a joint statement issued by banking regulators noted “an easing of CRE underwriting standards, including less-restrictive loan covenants, extended maturities, longer interest-only payment periods and limited guarantor requirements.” The statement went on to remind financial institutions of recommended risk management practices for commercial real estate lending and indicated that bank examinations during 2016 would include a review of CRE lending activities and the application of risk management guidance.

Lenders were responsive to this statement and in April and July 2016, the Senior Loan Officer Opinion Survey on Bank Lending Practices conducted by the Federal Reserve Board indicated that lending standards had tightened. In July 2016, loan officers indicated that lending standards are tighter now than the midpoint of the range prevailing since 2005 and that standards applied to refinancing maturing CMBS loans would be “somewhat tighter” than the standards applied to other commercial real estate loans.

### Regulatory changes impacting CMBS markets

Credit risk retention rules which were part of the Dodd-Frank Wall Street Reform and Consumer Protection Act are scheduled to come into effect in December 2016. The regulations require lenders originating CMBS loans to retain 5 per cent of each new CMBS deal either through vertical risk retention, whereby the sponsor retains 5 per cent of the face value of each class of securities issued or through horizontal risk retention, and the sponsor or an investor (eg a B-piece buyer) holds 5 per cent of the fair value of the issuance through holding the first loss position for a minimum of five years. (Note that sponsors can also utilize an “L-shaped risk retention” through a combination of vertical and horizontal risk retention as long as 5 per cent of the aggregate value of the CMBS issuance is retained.) Deutsche Bank has estimated that B-piece buyers would be likely to require an additional 3–5 per cent in returns for the additional risk of holding larger first loss positions for a minimum holding period.

### Conclusion—what should owners and investors do?

The challenges of refinancing demand that owners start the process early and consider a range of lenders. Instead of focusing on individual properties, sequentially by maturity date, we recommend taking a holistic view—considering the entire portfolio, development pipeline, tax issues, legacy issues, etc. Investing additional equity may be a key element to refinancing imminent debt maturities.

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