

## II. KOMENTARZE, OPINIE, POLEMIKI

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### **Best Practices in Real Estate Cross-border Transactions**

#### **Introduction**

Transactions on real estate markets have several aspects that make them highly complex, mostly due to their individual nature – each property is unique in terms of its location, structure and history. Real estate has historically been viewed as a local phenomenon, but nowadays real estate firms and investors have extended their area of operations beyond local markets to a world-wide base.<sup>1</sup>

The rise of global real estate investment in the late 1990s and the first decade of the twenty-first century make buyers increasingly look beyond their own borders for lucrative investments. JLL (Jones Lang LaSalle) reported that in 2018, of the \$733 billion direct investment in commercial property, \$212 billion – 30 percent – was cross-border, an increase from the 29 percent share of 2017.<sup>2</sup> Data on cross-border real-estate investment flows show that they obey gravity, but this relationship is rendered insignificant by controlling for the presence of counterparties

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<sup>1</sup> A. Bardhan, C.A. Kroll, *Globalization and the Real Estate Industry: Issues, Implications, Opportunities*, Sloan Industry Studies Annual Conference (April 2007), 1–36. Retrieved from <http://web.mit.edu/sis07/www/kroll.pdf> (accessed: 5<sup>th</sup> of March 2020).

<sup>2</sup> JLL, *Global Market Perspective*, February 2019.

from origin countries in destination countries.<sup>3</sup> Nonetheless, buyers of commercial real estate still have an unusually strong tendency to transact with sellers from their own country of origin.<sup>4</sup> Same-country matching rates rise substantially in locations in which the rule of law is weak, suggesting that contracting frictions and trust are the principal drivers of this tendency.

International real estate investment is broadly classified as either public or private. Public real estate, referred to as Real Estate Investment Trusts (REITs), uses the pooled capital of numerous investors to purchase, manage and develop income-generating properties. REITs are required to distribute at least 90 percent of their income to shareholders annually in the form of dividends. Private real estate investment funds, such as real estate private equity funds, have a specified exit timeline, typically six to eight years.<sup>5</sup>

In view of the above, the challenges faced by a lawyer dealing with real estate transactions change significantly. In his article, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, in the Yale Law Journal, Professor Ronald Gilson suggests that business lawyers are transaction cost engineers. On that basis, he proposes sweeping changes for the training of business lawyers in law schools.<sup>6</sup> In the face of the increasing number of transactions with cross-border elements, lawyers also become a transaction coordinators, who must anticipate possible risks and cooperate with fellows from other jurisdictions (often many) so as to be able to bring the transaction to a satisfactory conclusion without prejudice to the client.

In order to properly carry out an international transaction in the real estate market, it is necessary to comply with the specific rules that are applicable in international trade. We can distinguish various guidelines that will help us achieve the intended goal. This article presents most important of them.

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<sup>3</sup> C. Badarınza, T. Ramadorai, Ch. Shimizu, *Gravity, Counterparties, and Foreign Investment* (March 25, 2019). Available at SSRN: <https://ssrn.com/abstract=3141255> or <http://dx.doi.org/10.2139/ssrn.3141255> (accessed: 5<sup>th</sup> of March 2020).

<sup>4</sup> T. Chaney, *The network structure of international trade*, "The American Economic Review" 2014, vol. 104(11), 3600.

<sup>5</sup> L. Phalippou, *Hilton Hotels: A Case Study in Real Estate Private Equity* (April 5, 2014). Available at SSRN: <https://ssrn.com/abstract=2429357> or <http://dx.doi.org/10.2139/ssrn.2429357> (accessed: 5<sup>th</sup> of March 2020).

<sup>6</sup> R.J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE LJ. 1984, 239, 241.

## 1. Why you need local counsel

A cross-border real estate transaction may be extremely complicated, requiring the establishment of local companies or, for tax reasons, a company in a third jurisdiction, and multiple agreements among several parties in multiple jurisdictions. In practice, there are no typical transactions and there are huge differences in the manner of execution and scale.

Parties to such deals often come from diverse cultural backgrounds and sensitivities, language experience, and business practices. Local counsel will help avoid offending cultural sensitivities and miscommunications. Even inside supposedly uniform jurisdictions, such as the European Union or United States, local rules on property rights vary enormously from state to state. In countries external to the US/EU, rules involving property ownership can be even more obscure.<sup>7</sup>

The heavily repetitive nature of real estate market creates high barriers to entry for many lawyers. While they may have substantial reputations in their own jurisdiction, unless they have been part of a law firm that has traditionally done cross-border real estate transactions or been mentored by a lawyer who so engaged, it is very difficult to break into the international real estate market, as banks and clients are risk-averse.<sup>8</sup> Identifying them is relatively straightforward, as legal directories, e.g. *Legal 500* and *Chambers* provide information and data for the international legal community. This puts the real estate lawyer in a key position: it is up to the lawyer to create a structure that will satisfy not merely the immediate needs of investors and funders, but accommodate local jurisdictional needs without compromising the essential aspects of the transaction. Having a network of law firms that can adopt an international mentality when required is a necessary part of the lawyer's armory. Despite rapid globalization, it should be noted that real estate is still primarily influenced by local factors. Local knowledge, local economies, local actors and local institutions will continue to play the significant role.

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<sup>7</sup> For example, in Indonesia no person other than a resident can acquire any immovable property in Indonesia, whereas in the Philippines, only Filipino citizens and Filipino-controlled corporations are entitled to own or acquire land. In China, the requirements for the acquisition of residential properties vary slightly from one city to another. In Thailand, foreign individuals or companies can own land in limited situations only.

<sup>8</sup> J.A. Flood, E. Skordaki, *Structuring Transactions: The Case of Real Estate Finance* (Revised Version: March 2008), CONTRACTUAL CERTAINTY IN INTERNATIONAL TRADE, V. Gessner (ed.), 2008. Available at SSRN: <https://ssrn.com/abstract=1540615> or <http://dx.doi.org/10.2139/ssrn.1540615> (accessed: 5<sup>th</sup> of March 2020).

## 2. How important is due diligence

The proper conduct of the due diligence process is one of the most important good practices in the course of real estate transactions. International surveys show that 90% of foreign investors decide to have due diligence conducted. Such research makes it possible not only to know the acquired real estate, but also to identify potential risks in detail. Due diligence is an essential and regular part of the pre-acquisition process.

Legal due diligence seeks to provide legal security and to create the background for a business decision. Moreover, it forms a basis for conducting other research, i.e. financial, technical and tax. It involves the examination of all legal aspects relevant to the transaction and is based on data which have been made available by the seller, or which are made public in various types of registers and records, or which have been made available and disclosed by private companies collecting and aggregating data from the market.

While it is always important to carry out a proper due diligence process, it is of particular importance for clients from other countries and cultures. The scope of the research and the topics it will involve will vary depending on the region, its legal culture or the local specifics, e.g. the political or environmental risk. Due diligence is increasingly essential in all dimensions as pressure mounts, from international sanctions and extraterritorial legislation on conducting business abroad. Due diligence methods must take into account the target jurisdiction's legal rules, local customs and traditions.

Performing a proper search requires i.a. the lawyer to review ownership and title to the real property, zoning plan and building permits, lease agreements, restrictions on foreign ownership.<sup>9</sup> The experience shows that a number of issues spotted during due diligence can be remedied during the process.

A common law *caveat emptor* maxim warning a purchaser that he could not claim that his purchases were defective unless he protected himself by obtaining express guarantees from the vendor shall be taken into account. In civil law jurisdictions, the practice of courts deciding on the scope of liability is relevant for determining the consequences

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<sup>9</sup> IBA Corporate and M&A Law Committee Legal Due Diligence Guidelines, September 2018.

and importance of due diligence. The general trend indicates that the fact that the buyer acquires knowledge on the basis of his own research affects the primary limitation of the seller's liability.

### **3. Think about the legal structure of transaction**

Most people think in terms of location as the prime attribute of the transaction. For lawyers, however, the transaction structure is of paramount importance. There are three major types of legal structure that come into play: an asset deal, a share deal or an enterprise deal. Whether the share deal, asset deal or enterprise deal is more attractive is to be determined by the respective tax and entrepreneurial basis.

Secondly, legal counsel should assist in deciding in which legal form the special purpose vehicle (or entity) should be framed. An SPV very often operates as a limited liability company. The legal framework also depends on the type of financing to be used in the transaction. In the EU, mortgage-backed loans (Germany and Belgium), joint venture or bonds (UK) are most commonly employed mechanisms.

In a cross-border context, lawyers are required to create structures that address both real estate and corporate issues. This means that a decision as to the structure or vehicle to be used for purchases should be based on both legal and investment factors (e.g. relative political and economic stability, strong market fundamentals, access to capital, the potential for advantageous regulatory and tax reform).

### **4. Title insurance as a mitigating risk tool**

Most businesses buy insurance against a variety of hazards. When a firm takes out insurance, it is simply transferring the risk to the insurance company. Insurance companies have numerous advantages in bearing the risk. Firstly, they may have experience in insuring similar risks, so they are well placed to estimate the probability of loss. Secondly, they may have knowledge about the methods of reducing the risk by providing advice to companies.<sup>10</sup>

Title insurance is purchased for a one-time fee at closing and is valid for as long as the owner has an interest in the property. Insurance is

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<sup>10</sup> R. Brealey, S. Myers, F. Allen, *Principles of corporate finance*, International edition 2008.

designed to protect the buyer and should help to cover the title when a problem regarding the title that was not identified during the title search arises. Based on that, title insurance is a popular tool to mitigate the possible risk when investing in a foreign jurisdiction, reducing the uncertainty of property rights.<sup>11</sup> However, there is some misperception of the title insurance by the buyers originating from outside the US/EU jurisdictions on how title insurance works. They tend to think that all the issues are covered, as they have a title policy. However, title policies have many exceptions and hidden risks which we, as legal advisors, should take into consideration.

## 5. Consider cultural approach

The physical and cultural distance between the parties may possibly cause differences, which obviously could be easily avoided. In many societies, there are more untypical forms of law, like customary law, indigenous law, religious law, or law connected to distinct ethnic or cultural groups<sup>12</sup> which we should always be aware of to avoid any misunderstandings. One example of a cultural approach that should be taken into account in respect of a real estate transaction is the growth in Sharia-compliant transactions.<sup>13</sup> The structure of participating funds allows investors to benefit from western-style bank financing without violating Sharia law. There are country-specific guides available<sup>14</sup>, which

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<sup>11</sup> M. Boyer, Ch. Nyce, *Market Growth, Barriers to Entry, and Banks as Insurance Referral Agents: Evidence from the Title Insurance Industry* (February 2005). Available at SSRN: <https://ssrn.com/abstract=886505> or <http://dx.doi.org/10.2139/ssrn.886505> (accessed: 5<sup>th</sup> of March 2020).

<sup>12</sup> Z.B. Tamanaha, *Understanding Legal Pluralism: Past to Present, Local to Global*, "Sydney Law Review" 2007, vol. 29; St. John's Legal Studies Research Paper No. 07-0080. Available at SSRN: <https://ssrn.com/abstract=1010105> (accessed: 5<sup>th</sup> of March 2020).

<sup>13</sup> N. Mersadi Tabari, *Islamic Finance and the Modern World: The Legal Principles Governing Islamic Finance in International Trade*, "The Company Lawyer" 2010, vol. 31, no. 8, pp. 249–254. Available at SSRN: <https://ssrn.com/abstract=1740669> (accessed: 5<sup>th</sup> of March 2020).

<sup>14</sup> India: Cross-Cultural Business Behavior for Business People, Expatriates and Scholars. 3 Moreover, there are others that address the issue of dealing with negotiators from different countries, such as "Part 2: Country-by-Country Guide to International Business Negotiations" of *The ABA Guide to International Business Negotiations: A Comparison of Cross-Cultural Issues and Successful Approaches*, 3rd Edition, 4 and "Part Two: Forty Negotiator Profiles" in *Cross-Cultural Business Behavior: Negotiating, Selling, Sourcing and Managing Across Cultures*.

may be helpful in understanding the cultural discrepancies between the countries. Cultures differ enormously when it comes to decision making, particularly in how quickly decisions should be made and how much analysis is required beforehand.<sup>15</sup> Both lawyers and business leaders were found to have a distinctive national style depending on their origins: the US/EU decision style reflects a comparatively higher need for achievement, while Asian decision styles reflect comparatively high needs for affiliation and personal power.<sup>16</sup>

## Conclusions

Cross-border transactions on the real estate market are becoming more and more popular as the world becomes more globalized. The increasing volume of this type of transaction poses a challenge for the modern real estate lawyer. The key to determining the risks and structure of the transaction is to identify the client and the nature of the project. It is impossible to create an exhaustive guide setting out all the hazards occurring in this type of transaction. The specificity of the real estate market make sit all the more difficult to develop universal guidelines. There is, however, a certain list of steps that a professional lawyer should follow in order to avoid potential difficulties and to provide the client with legal security. This article addresses this difficult challenge by pointing out the most important of these steps.

It is essential and extremely helpful to enter into cooperation with a local counsel who will help us to explain the local specificity and who will take legal differences into account. In addition, other helpful tools, such as a legal due diligence report or a title insurance Policy, should be carefully considered. One cannot forget about the importance of local culture and customs, which may prove decisive at the crucial moment of the transaction. Finally, to be effective in working with cross-border clients, lawyers must have a good understanding of how people think and make decisions, and must possess good people skills.

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<sup>15</sup> V. Misra, *Management of Cross Cultural Teams: Problems and Effective Management of Cross-Cultural Teams* (November 30, 2012). Available at SSRN: <https://ssrn.com/abstract=2183174> or <http://dx.doi.org/10.2139/ssrn.2183174> (accessed: 5<sup>th</sup> of March 2020).

<sup>16</sup> M.G. Martinsons, *Comparing the Decision Styles of American, Chinese and Japanese Business Leaders*. Best Paper Proceedings of Academy of Management Meetings, Washington, DC, August 2001. Available at SSRN: <https://ssrn.com/abstract=952292> (accessed: 5<sup>th</sup> of March 2020).

Being open-minded, patient, far-sighted and sometimes prudent can be helpful in dealing with the majority of cross-border transactions. Respect for local customs and traditions, as well as understanding the local legal system, while securing clients' interests, is the key to a successful transaction.

## BEST PRACTICES IN REAL ESTATE CROSS-BORDER TRANSACTIONS

### Summary

The article presents reflections on the best practices in real estate cross border transactions. Transactions on real estate markets have several aspects that make them highly complex, mostly due to their individual nature – each property is unique in terms of its location, structure and history. Cross-border transactions on the real estate market are becoming increasingly popular as the world becomes more globalized. The growing volume of this type of transaction presents a challenge for the modern real estate lawyer. It is impossible to create an exhaustive guide setting out all the hazards occurring in such transactions. This article addresses this difficult challenge by indicating the most important of them.

It is essential and extremely helpful to enter into cooperation with a local counsel who will help us to explain the local specificity and who will take the legal differences into account. In addition, other helpful tools, such as a legal due diligence report or a title insurance Policy, should be carefully considered. One cannot forget about the importance of the local culture and customs, which may prove decisive at the crucial moment of the transaction. Finally, to be effective in working with cross-border clients, lawyers must have a good understanding of how people think and make decisions, and must possess good people skills. Respect for local customs and traditions, as well as understanding the local legal system while securing clients' interests, is the key to a successful transaction.

**Keywords:** best practices – cross-border transactions – real estate transactions

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