



Blockchain Technology and its Applicability to the Practice of Real Estate Law

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Real estate transactions are steeped in traditions that have hardly changed over hundreds of years. Today, as computer-based property recording systems are prevalent in our cities but roll out at a snail's pace in rural areas (often hindered by strained municipal budgets), and e-signatures are little used (due to legitimate fears of fraud), arguably the real estate closing process has lagged in its use of computer aided technology. Yet other aspects of real estate ownership have been transformed by the internet: smart home

technology to remotely control heating and lighting and monitor security; Airbnb which increases the value of real estate ownership and disrupts the hotel industry; and the real estate brokerage community's design/photographic/communication technology to list and virtually show properties. Now add to our brave new world blockchain, a cloud-based decentralized ledger system that could offer speed, economy and improved security for real estate transactions. Will the real estate transaction industry avoid or embrace it?



WHAT IS BLOCKCHAIN?

Blockchain is best-known as the technology behind bitcoin, however bitcoin is not blockchain. Bitcoin is an implementation of blockchain technology. Blockchain is a data structure that allows for a digital ledger of transactions to be shared among a distributed network of computers. It uses cryptography to allow each participant on the network to manipulate the ledger in a secure way without the need for a central authority such as a bank or trade association. Using algorithms, the system can verify if a transaction will be approved and added to the blockchain and once it is on the blockchain it is extremely difficult to change or remove that transaction. A blockchain can be an open system or a system restricted to permissive users. There can be private blockchains (for ownership records or business transactions, for instance) and public blockchains (for public municipal data, real estate records etc.). Funds can be transferred by wires automatically authorized by the blockchain or via bitcoin or other virtual currency. Transparent, secure, frictionless payment is touted as one of blockchain's many benefits.

HOW DOES A BLOCKCHAIN DIFFER FROM A RECORD KEPT BY A FINANCING INSTITUTION OR A GOVERNMENT AGENCY?

In a blockchain, there is no third-party intermediary verifying the veracity of the transaction, rather it is verified by "nodes." A "node" is a transaction between computers. Each node contains the history of a transaction down to the "genesis block" or beginning block. Once a command is made to execute a transaction, the node will trace through the history of the blockchain all the way to the genesis block to confirm that the new transacting party is "cleared" to join the block. The new block can then be added to the chain, which creates an indelible and transparent record of transactions.

HOW IS A BLOCKCHAIN TRANSACTION MORE SECURE THAN ANY OTHER TRANSACTION?

In theory, blockchain is tamper-proof because it is decentralized and not controlled by one party. All the nodes maintaining the same database will be involved in verifying the transaction which is a check on the veracity of the system. The

system is analogous to creating a unique digital fingerprint (or "hash") for each transaction that is stored in the database by each member of the blockchain. The hash is validated by algorithms and only can be changed if the utilized consensus mechanism verifies that the transaction is legitimate. This assures secure and authenticated transactions. Is blockchain inviolable? Time will tell.

HOW WIDELY IS BLOCKCHAIN USED?

During the past three years, over \$1.4 billion in venture capital has been invested in blockchain research and development and more than 2,500 patents have been filed. A consortium of over 90 corporations is working to design and apply distributed ledger technologies ("DLT") to global financial markets. See The future of financial infrastructure: An ambitious look at how blockchain can reshape financial services, World Economic Forum, (August, 2016), http://www3.weforum.org/docs/WEF_The_future_of_financial_infrastructure.pdf. (Note that DLT does not have a single definition. Generally the term refers to the technology as

some combination peer-to-peer networking, distributed data storage, and cryptography that, among other things, could change the way in which the storage, recordkeeping, and transfer of a digital asset is done.) Other firms across a variety of industries are experimenting with DLT as a transparent and secure manner to digitally track the ownership of assets. See Nathan Popper, Business Giants to Announce Creation of a Computing System Based on Ethereum, *The New York Times*, February 27, 2017. Generally, blockchain is viewed as a way to speed up transactions, cut costs, and reduce fraud. See Steven Norton, CIO Explainer: What is Blockchain? *The Wall Street Journal*, February 2, 2016. For example, now a banking transaction must go through a clearing house which delays the settlement of the transaction and generates a fee (anecdotally, ranging from 12-20 percent of the transaction amount). DLT can address these frictions through improved end-to-end settlement speed, data auditability, resilience, and cost efficiency. Fees per transaction could be reduced to a decimal percentage of a penny. These are significant benefits to commerce.

One issue proponents of blockchain technology face is that members of the block chain must agree on a common network protocol and technology stack. To date, there is an uncertain and unharmonized regulatory environment as well as no formal legal framework in which to conduct transactions. There are also many lingering questions about privacy and security. Nonetheless, blockchain seems to be the nascent next generation of transformative financial services infrastructure. See Avi Spielman, *Digitally Rebuilding the Real Estate Industry*, Massachusetts Institute of Technology Thesis, September, 2016.

But how might Blockchain affect the real estate industry and the practice of real estate law?

THE USE OF BLOCKCHAIN TO RECORD REAL PROPERTY INSTRUMENTS

Blockchain could change the way real property transfers and encumbrances are recorded in the United States. Currently, the local recorder's office (typically on a county by county basis) records and maintains property records such as deeds, mortgages, easement and covenants and restrictions. According to the U.S. Census Bureau, as of 2013, there were a total of 3,143 counties (and county-equivalents) in the nation. Spielman Thesis, page 6. Consequently, the U.S. real property recording system is disconnected and decentralized because each state government and each local government has a role in local real estate ownership and has latitude to create its own laws, recording requirements and fee structures. This fragmented and local nature of real estate is why local state counsels are necessary to close multi-state real estate transactions.

Notably, in 2016, the Cook County Recorder's office in Illinois announced that it will experiment with the use of blockchain technology for transferring and tracking real property titles and other public records. The Cook County Recorder's Office, which handles real property transactions in Chicago, is the second largest recording office in the U.S., and is the first in the country to try out blockchain technology. Specifically, the office will test blockchain applications of property title transfers and a system for filing liens, compatibility between a blockchain and a traditional, server-based setup, fraudulent use prevention and conveyances of vacant property in Chicago. See Kyle Torpey, *Chicago's Cook County to Test Bitcoin Blockchain-Based Property Title Transfer*, *Bitcoin Magazine* (Oct 6, 2016). Earlier in 2016, the government of Vermont released a report regarding the potential use of blockchain technology for public record keeping. See James Condos, William H. Sorrell and Susan L. Donegan, *Blockchain Technology Opportunities and Risks* (January 15, 2016), [http://legislature.](http://legislature.vermont.gov/assets/Legislative-Reports/blockchain-technology-report-final.pdf)

[vermont.gov/assets/Legislative-Reports/blockchain-technology-report-final.pdf](http://legislature.vermont.gov/assets/Legislative-Reports/blockchain-technology-report-final.pdf). Although local municipalities are recorders only and do not warrant the accuracy or correctness of what is recorded, the Illinois and Vermont projects seem to indicate a desire to further secure and streamline those states' existing systems of land ownership records. Further, it is reported that Sweden, Honduras, The Republic of Georgia, and Ghana have all implemented blockchain-based systems for recording real estate ownership. See Luke Parker, *City of Rotterdam to use a Blockchain for Lease Agreements* (December 12, 2016), <http://bravenewcoin.com/news/city-of-rotterdam-touse-a-blockchain-for-lease-agreements>.

PREVENTION OF FRAUD

The recording systems in use today are susceptible to abuse by fraud. Although the variety of fraudulent schemes is as broad as the imagination, some involve identity theft, others, fraudulent manipulation and filing of false documents. An all-too-familiar example: fraudster knows that a home is owned by an absent or elderly individual; fraudster files a forged deed based on documents openly available on the county website and then sells the property, pocketing the purchase price, and leaving behind a tale of woe.

Because blockchain relies on encryption to validate transactions by verifying the identities and obtaining the consent of all parties involved, "false" transactions cannot be added to the blockchain. Accordingly, proponents argue that blockchain could resolve many of the fraud issues arising from identity-theft and fraudulent-payment schemes. However, many types of real estate fraud do not involve filing false documents and those schemes may not be prevented by the use of blockchain.

Blockchain technology relies on a public key and a private key--passwords effectively--held by the party in-putting information. Currently, if a private key to the blockchain is lost or stolen, there is no recourse available under existing



Retail Redefined: What's Next for Retailers?

*By Andy Gutman
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At a time when the retail industry is changing so rapidly, and retail real estate realities are shifting at an unprecedented pace, commercial real estate professionals are striving to set their sights on what comes next. Those who want to remain competitive are working hard to be proactive, and to think both creatively and strategically about not only what

next year looks like, but also what the next five to 10 years will look like.

The challenge, however, is that making accurate predictions becomes even harder when the pace of change is so remarkable that the contours of the retail real estate landscape can look radically different just a year or two later. Overcoming

that challenge means developing a clear understanding of both why and how retail is redefining itself—and what major social and economic trends are driving that process.

With a steady stream of headlines announcing store closings and consolidations, the narrative that brick-and-mortar retail is struggling—

perhaps even failing—in the face of competition from online and mobile shopping has grown stronger in recent years. While that may be hyperbole, it is clear that brick-and-mortar environments need to change.

Owners, operators, developers and architects who want to accommodate the growing influence of the Millennial demographic and find new ways to appeal to consumers who increasingly demand more experience with their retail need to rethink some long-held assumptions. They need to find new ways to make brick-and-mortar environments more compelling and engaging, and introduce more lifestyle elements into the retail equation. What follows are some of the trends that are making that happen—and that commercial real estate professionals should consequently be paying very close attention to.

RENOVATION, REDEVELOPMENT & RE-USE

As online retailers like Amazon continue to expand their reach and offer new services (such as same-day service through new distribution centers, and the promise of drone deliveries in the not-too-distant future), many traditional retailers will be forced to either adapt or shut their doors.

Some retail formats will be particularly challenged—traditional enclosed malls have been (and will likely continue to be) one of the hardest hit by this online competition. As struggling malls close and others undergo renovations and redevelopments, the question of what to do with defunct or under-performing properties becomes more urgent. In some cases, a renovation can be transformative, adding a new residential or entertainment

component, introducing new dining options and finding new uses for underutilized space.

In fact, with so much retail space available and more coming on the market, I expect to see the creative reuse trend continue, as well. In some cases, a former mall or retail center could become a source of inexpensive office space. Ford, for example, has put some of its business units into the former Dearborn Mall in Michigan. While the cost and access to amenities are pluses, questions remain about the viability of this model. At a time when brands and businesses are looking for chic and unique office spaces, a repurposed mall might not be exactly what the doctor ordered.

ENTERTAINMENT & EXPERIENCE

Entertainment is one of the fastest-growing retail segments, and entertainment anchors have

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blockchain technology. In a worst case scenario, the loss or compromise of a private key is tantamount to loss of control over all of one's transactions within the blockchain. A malevolent party could pose as the user until the private key is deactivated in the same manner a thief could continue spending on a stolen credit card until it is canceled. See Spielman Thesis, page 37. A blockchain network cannot distinguish between transactions performed by a legitimate user or a malevolent actor with unauthorized access to the legitimate user's private key. So long as protocols are properly followed, bad data can be input, accepted and added to the blockchain. See James Condos, William H. Sorrell and Susan L. Donegan, Blockchain Technology Opportunities and Risks (January 15, 2016), <http://legislature.vermont.gov/assets/Legislative-Reports/blockchain-technology-report-final.pdf>, citing L. Duranti and C. Rogers, Trust in digital records: An increasingly cloudy legal area, Computer Law & Security Review, 522-531 (October, 2012). Like other databases, blockchain is susceptible to the principle "garbage in, garbage out." See Spielman Thesis, page 57. Nonetheless, except where there is illicit system/key infiltration, blockchain should significantly reduce low level, less sophisticated fraud. Like so much of blockchain's architecture, the cybersecurity elements continue to evolve.

HOW MIGHT BLOCKCHAIN AFFECT THE ROLE OF TITLE INSURANCE COMPANIES?

Today, it is standard practice in most transactions for a purchaser to order a title search, which at closing, after payment of a premium, becomes a title insurance policy. Many advocates of blockchain technology believe that someday it will eliminate the need for title insurance thereby reducing transaction costs and accelerating the speed of real estate transactions. A Goldman Sachs report, entitled, "Blockchain: Putting Theory into Practice," estimates that about 70% of title search requests are found to be without defect and approximately 30 percent of title policy requests are found to have title defects of some type. In these instances, title companies rely on an in-house network of labor to manually review (abstractors) and clear (underwriters) title issues.

It has been estimated that if the title insurance industry were not searching and clearing titles, the occurrence of title defects would double in 12 years, from approximately 25 percent (at the time of the 2003 study) to roughly 50 percent. For owner-occupied single family residences, the defect rate would rise to about 65 percent over the same period. This illustrates the curative nature of the title underwriting process.

Title insurers and title insurance agents examine and repair public records on an ongoing basis, not just to correct fraud and mistake, but to update for accuracy, which otherwise would deteriorate with the events of everyday life. Property owners marry and divorce, have children (legitimate and illegitimate), and die; mortgages are recorded, then satisfied, mechanics' liens are filed, then released. A wide variety of disputes can lead to claims against real property. See Spielman Thesis, page 28.

Title insurers also deal with claims that do not involve a total failure of title: nuances of covenants and restrictions, easements and other issues. In addition to paying an insured's loss in the event of a sustained claim, title insurance also (and more frequently) absorbs the insured's legal defense costs. Presumably the implementation of a blockchain recording system would have no effect on this critical aspect of title insurance.

IMPLEMENTING BLOCKCHAIN IN THE U.S. LAND TRANSFER RECORDING SYSTEM

Certain concerns about blockchain could hinder a wholesale reinvention of the U.S. land transfer recording system. Currently, local governments control land transfers. Political resistance to giving up this control would seem likely, unless, for instance,

it were part of a broader program to privatize government functions. The existing public land records provide transparent notice to all. The parties that rely on this recording system to protect the priority of their liens, deeds and other encumbrances might push back out of an aversion to change. Most significantly, getting all real property transaction constituents (municipalities, property owners, banks, taxing authorities, attorneys and courts) to agree to uniform protocols and standards as well as payment processes will be a lengthy negotiation. Retraining current land record employees to work in the blockchain system also could be challenging. Nonetheless, in recent years, a number of land recorder offices all over the nation have upgraded to electronic recording to the point that it is routine in certain jurisdictions to have all land records and tax payment systems available on line.

8 Although this article focuses on the potential use of blockchain to record land transfers, even prior to such a sea change, blockchain has already become part of a real estate transaction. On July 22, 2016, BlockChain. HK reported that Ubitquity, a company which devised a blockchain real property transfer platform actually used its technology in the settlement of a home transfer. The home was purchased by Atlantic Sotheby's International Realty chief real estate officer. See Real estate platform Ubitquity first successful use of the block chain technology transfer of property (July 22, 2016), <http://news.blockchain.hk/real-estate-platform-uses-blockchain-property-transfer/>. So it seems that even if the U.S. real property recording system is never changed, blockchain technology may be coming to the real estate industry in other ways.

Weighing the potential benefits against the legitimate concerns about blockchain technology suggests that a transformation of the U.S. land transfer recording system will not happen overnight, if ever, nor

will the title insurance industry become redundant. It does seem likely, however, that some aspects of blockchain may be incorporated by both land recorder offices and the title insurance industry. Streamlining land transfers and reducing fraud are goals worth achieving.

SMART CONTRACTS

Smart contracts are another aspect of blockchain technology that may affect future real estate transactions. According to Misadium, a London based company that launched in this space, "the smart contract... is a digital representation of the mutual agreements contained in a traditional real estate contract as lines of software code that self-executes and self-enforces. It has the power to move funds between bank accounts, transfer property titles and reconcile payments. At any time, a smart contract can be converted to a traditional contract form for legal purposes." See <http://midasium.com/smart-contracts>. It appears that "the lowest-hanging fruits today are applications in which contracts are narrow, objective, and mechanical, with straightforward clauses and clearly defined outcomes." See John Ream, Yang Chu, and David Schatsky, Upgrading Blockchain: Smart Contract Uses in Industry (June 08, 2016), <https://dupress.deloitte.com/dup-usen/focus/signals-for-strategists/using-blockchain-for-smart-contracts.html>. Real estate contracts can get complicated quickly. However, a smart contract could be used, for instance, in a very simple storage locker or residential property lease. Areas of the country where adhesion forms are common would more likely accept the use of smart contracts. In the Netherlands, it was recently announced that the city of Rotterdam will use a blockchain to record lease agreements for the Cambridge Innovation Center ("CIC"), enabling the city and companies housed in CIC office space to conclude contracts faster and easier than before. See Luke Parker, City of Rotterdam to use a Blockchain for Lease Agreements (December 12,

2016), available at <http://bravenewcoin.com/news/city-of-rotterdam-to-use-a-blockchain-for-lease-agreements>.

CONCLUSION

Change is inevitable even to the practice of real estate law. That said, the wholesale transformation of our varied state by state real property recording systems into a single uniform blockchain system seems far in the future, if ever. Nonetheless, it is possible, even likely, that aspects of blockchain technology may be integrated into our current system. Using blockchain technology, party to party money transfers could be made faster, cheaper and more securely. Smart contracts could drive transactions where consumers typically sign adhesion contracts, but in large dollar transactions with sophisticated parties represented by attorneys, document negotiations will likely persist. Notwithstanding the reservations about blockchain, the smart money is betting on its implementation. It is definitely something to watch and be able to adapt to. Ignore blockchain at your peril.

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Sale-Leaseback Transaction

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UNLOCKING EQUITY TO GROW YOUR BUSINESS

Is your company's investment in real estate and buildings the key to your capital needs for growth in your core business? When it comes time for raising capital for expanding business operations, many companies overlook the equity in their real estate holdings as a viable, and potentially less-expensive, source for capital. Before committing to mezzanine financing or refinancing real estate debt to raise needed funds,

astute advisors recommend evaluating a sale-leaseback as an alternative.

WHY CONSIDER A SALE-LEASEBACK?

In the simplest terms, if your company owns the building(s) in which you conduct your primary business, your "secondary business" is that of real estate investor. You have capital tied up in real estate that could be working for you to grow your markets, invest in equipment, or acquire a competitive advantage. A sale-

leaseback enables a company to reduce its investment in non-core business assets (the land & building) and liberate the cash. At the same time, it allows you to control and occupy the real estate under terms you negotiate prior to the sale. Demand for real estate investments is at an all-time high in Utah – meaning the value of your buildings may be higher now with a sale-leaseback than you might expect. It makes sense to compare the value of your real estate to the cost of funds obtained through other avenues.

WHY CHOOSE A SALE-LEASEBACK?



IMPROVE YOUR
BALANCE SHEET



GROW YOUR
BUSINESS



MONETIZE
INVESTORS



PLAN FOR
THE FUTURE

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WHAT IS A SALE-LEASEBACK?

A real estate sale-leaseback is a transaction in which the owner-occupant sells the land and building used in its business operations to a real estate investor whose goal is to find consistent cash flow backed by the underlying value of the real property and/or the strength of the tenant. Concurrently with selling the property, the seller enters into a lease with the new owner at terms agreed upon at the time of the purchase contract negotiation. Factors that will influence sales price for the real estate include the rent negotiated, the length of the lease, the underlying value of the real estate, and the strength of your company to guarantee the lease.

ADDITIONAL BENEFITS:

In the right set of circumstances, a sale-leaseback transaction can have several benefits for your company.

- **Tax Savings:** A sale-leaseback may have a greater tax advantage for your business than owning your real estate. Generally, if you lease rather than own, you can write off your total lease payment as an expense for tax purposes. As property owners, the interest



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expense and depreciation were the only tax deductions available.

- **Set Your Own Lease Terms:** Because the seller is also the lessee, the seller has significant bargaining power in structuring the property lease. In addition to realizing their investment in the real estate, the lessee has the opportunity to negotiate an acceptable lease agreement with the investor acquiring the property. Typical leases in our market can run from 5 to 10 years or longer with options for renewal that are beneficial to the seller. If you have concerns about outgrowing the real estate, that can be addressed via buy-out clauses or sub-lease agreements.

CONCLUSION

A sale-leaseback transaction represents another alternative for companies seeking capital for growth and operations. It may also be a tax-advantaged occupier solution for your business. It is important to work with an experienced team including your Real Estate Advisor, Tax Professional, and Legal Counsel to structure a deal that meets your company's specific circumstances.

Tax Reform and Potential Impacts on the Real Estate Market

By Julie Baird, Vice President and Counsel, First American Exchange Company

Tax reform is coming. Or is it? At the time of writing this article, Republican leaders are giving mixed information about the prioritization and timing of tax reform versus health care reform, not to mention infrastructure investment and foreign policy initiatives. Congress and the President are still showing strong interest in overhauling the tax code with the stated goals of: (1) job creation and economic growth, (2) simplification, and (3) transformation of the IRS into a taxpayer focused agency. While there was an initial interest in signed legislation by August, it is now looking more likely to occur later in the year, if at all.

While no specific legislative text is available yet, the basis for much lobbying and speculation has focused on the Republican plan called "A Better Way Forward on Tax Reform" (referred to as the "Better Way" throughout this article).¹ This plan provides a blueprint of ideas and concepts to achieve the above goals.

The Better Way calls for three tax brackets for individuals and for lowering corporate tax rates. The desired goal for the corporate rate has fluctuated between 15%-22%, down from the current federal rate of 35%. The plan also calls for a 50% exclusion on capital gains, lowering the effective rate.

According to the Urban-Brookings Tax Policy Center, the cost of these tax cuts could be close to \$3 trillion.² This is important because if the legislation is not budget neutral – i.e., a \$3 trillion



Julie Baird

cost - the Senate would need at least 60 votes to pass it. If the legislation is budget neutral, a process called "budget reconciliation" can be used which requires only a simple majority – or 51 votes – for the legislation to pass. Republicans currently have 52 members in the Senate, so if they can achieve party unity, the 51 vote threshold is an easier target.

In order to be budget neutral and use the budget reconciliation process, the tax cuts would either need to sunset within a 10-year time frame or would need to be paid for through increased revenue. Three major potential revenue raisers are possible. The first is the repeal and replacement of the Affordable Care Act. Replacement legislation relating to health care reform could lower or remove certain taxes. Eliminating these taxes could reduce the revenue baseline about \$1 trillion dollars which would mean making up less

revenue if the Better Way is going to be revenue neutral. This \$1 trillion impact is a big reason why health care reform was scheduled to be tackled first. With the potential challenges of passing health care reform, the budget baseline for revenue neutrality is \$1 trillion higher. A second revenue raiser is the use of "dynamic scoring" to score the legislation. Dynamic scoring (as opposed to static scoring) takes into account impacts on the greater economy due to the proposed legislation. Using dynamic scoring, the Better Way scored to raise roughly \$1 trillion. The final major revenue raiser would be the implementation of a Border Adjustment Tax ("BAT") which, very generally, would impose a tax on imports but not on exports. The BAT proposal has spurred much debate. Retailers and other industries that rely heavily on imports are opposed to the BAT and claim it would raise consumer prices. Large manufacturers support the idea of a BAT and claim the proposal would strengthen the dollar, wiping out the impact of any increase in prices. This debate could create a wedge making unified Republican support challenging, and recent developments indicate that the BAT idea has been taken off the table.

What does the Better Way say about real estate? The short answer is not much, but there are a few concepts in the plan that could have some significant impacts on transaction prices and volume.

One proposed tool provides for the immediate expense deduction of 100% of the cost of newly acquired tangible

and intangible business investments. Immediate expensing would apply to real estate improvements, but not land. This could impact larger commercial transactions in areas where land value is a larger percentage of overall price, and agricultural and farm land transactions. Additionally, the benefit of immediate expensing may be hard to implement or may run into opposition because it requires using the expensing in the same tax year as the income or gain the expensing is used to offset.

To pay for the immediate expensing benefit (remember the goal of revenue neutrality), taxpayers would lose the expense deduction for interest paid on business debt. This provision could significantly impact the commercial real estate market by increasing the cost of business debt.

Immediate expensing could create a strong initial incentive for acquisitions, however as a contributor to Tax Notes has observed: “[o]nce the up-front deduction has been used, there will be no depreciation deductions and no deduction for interest on debt incurred to finance the investment. At that point, the effective tax rate on income from the real estate investment will be significantly increased. Even though the GOP Blueprint purports to reduce tax rates to a maximum of 33 percent, these real estate investments will be subject to tax at effective rates that could exceed 66 percent or more. This tax increase will probably not be survivable for the overwhelming majority of property owners who rely upon debt to finance their investments.”³

The Better Way is silent on the retention or removal of Internal Revenue Code §1031 regarding like kind exchanges.⁴ This current tax code provision allows for the deferral of the payment of capital gains tax when property held for investment or used for business is exchanged for property of like kind. Opponents of this provision claim that it creates a loophole for wealthy developers and that its repeal would generate

revenue, helping with the goal of revenue neutrality. Supporters of this provision argue that this portrayal is inaccurate for a number of reasons.

First, §1031 exchanges provide a tax deferral tool, not a tax avoidance tool. The repeal would only temporarily speed up the collection of the tax dollars. Further, §1031 is one of the few reinvestment incentives available to and used by taxpayers of all sizes.

Exchange industry data shows that the majority of exchanges involve properties worth less than \$1,000,000. These types of properties typically belong to individual investors and small businesses. Instead of needing to cash out to pay taxes, utilizing a §1031 exchange allows these taxpayers to reinvest their entire sale proceeds to expand their businesses or diversify investment holdings.

In addition, real estate developers and “flippers” cannot take advantage of §1031. The properties owned by these types of taxpayers are considered inventory or property held primarily for sale and are specifically excluded from tax deferral treatment.

Finally, recent micro and macro-economic studies commissioned in response to legislative proposals to repeal §1031, document that elimination of §1031 would slow economic growth, reduce our gross domestic product (GDP) and hurt many U.S. small businesses.⁵

While we are hearing much discussion of impending tax reform, a major overhaul is proving to be very challenging. The bottom line is that the efforts to achieve significant tax reform will be interesting to watch.

1. Information and details about the plan can be found at <https://waysandmeans.house.gov/taxreform/>.

2. COLUMBIA JOURNAL OF TAX LAW, Vol.8:257, CAN ANALYSIS OF THE HOUSE GOP TAX PLAN, Leonard

E. Burman, James R. Nunns, Benjamin R. Page, Jeffrey Rohaly, and Joseph Rosenberg: <https://taxlaw.journals.cdrs.columbia.edu/wp-content/uploads/sites/10/2017/04/Burman.pdf>.

3. Letter to the Editor: GOP BLUEPRINT FOR TAX REFORM COULD DERAIL COMMERCIAL REAL ESTATE, Stephen M. Breitstone, Tax Notes: 2017 TNT 72-8 (April 17, 2017).

4. Prior to the publication of this article, President Trump released his proposed tax reform plan which is also silent on the retention or removal of IRC §1031. The President’s plan is similar to the Better Way, but does include lower corporate tax rates and does not mention the BAT.

5. A study completed by Ernst & Young, LLP quantifies that if IRC §1031 were to be repealed the segments of the economy supported by the ten most affected industries, including real estate, construction, truck transportation and equipment/vehicle rental and leasing, would suffer an annual year after year decline in GDP of \$27.5 billion. The study further concluded that a repeal of IRC § 1031 could lead to a decline in U.S. GDP of up to \$13.1 billion annually. A copy of the study is located here: <http://www.1031taxreform.com/wp-content/uploads/EY-Report-for-LKE-Coalition-on-macroeconomic-impact-of-repealing-LKE-rules-revised-2015-11-18.pdf>. In a 2015 study, David C. Ling, professor of real estate at the University of Florida’s Hough Graduate School of Business, and Milena Petrova, an assistant professor in real estate in the Whitman School of Management at Syracuse University, found that, among other things, repealing IRC §1031 like-kind exchanges would increase taxes for thousands of commercial property owners, reduce property values, increase rents and result in a decline of real estate activities. You can read more on this study here: <http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf>.



Recharacterization Issues in Sale-Leaseback Transactions

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*By John C. Murray, Vice President - Special Counsel
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INTRODUCTION

Sale-leaseback transactions are subject, under certain circumstances, to recharacterization as either equitable mortgages or joint ventures (although to date no final, reported court decision has recharacterized a sale-leaseback transaction as a joint venture). In a sale-leaseback transaction, the seller-lessee may attempt to have the sale and leaseback recharacterized as an equitable mortgage in order to, among other things, provide it with an opportunity to “redeem” the property at a foreclosure sale. The courts (including bankruptcy courts) have applied a fact-based analysis

to determine whether the substance of the transaction is in accord with its form and the expressed intent of the parties. Although the issue of whether a transaction is characterized as a sale or a mortgage depends to a great extent on the expressed intention of the parties, the economic substance of the transaction -- and not its label -- ultimately will determine whether it is a true sale-leaseback or a financing transaction. This article will examine the various factors considered, and tests utilized, by state and federal courts when determining whether to recharacterize a sale-leaseback transaction.

FACTORS CONSIDERED BY COURTS

Unfortunately, the courts are not consistent with respect to the relevance and weight of the factors that will determine whether a document designated as a lease will be recharacterized as a mortgage. The factors that the courts consider include the following:

- The intent of the parties at the time of the execution of the documents, as determined by examining the language in the documents and (if there is an ambiguity) by the aid of parol evidence.

- Whether there is continued evidence of a debt or liability.
- The relationship of the parties.
- Prior unsuccessful attempts to obtain a loan.
- The circumstances surrounding the transaction.
- The sophistication and circumstances of the parties.
- The lack of legal counsel.
- Whether the structure of the sale is unusual.
- The adequacy of consideration and whether the purchase price was related to the fair market value of the property.
- How the consideration was paid.
- Whether there is written evidence of the debt.
- The belief that the debt remains unpaid.
- Whether there is an option or agreement to repurchase.
- The continued exercise of ownership privileges, responsibilities and/or possession by the seller-lessee, including the obligation to pay property taxes and insurance.

- Whether there is a trading of tax benefits for a fixed return.
- Whether the rental payments were calculated to compensate the lessor for the use of the land or are in actuality are structured as a return on an investment.

For example, in *185 Wabash LLC v. Lake Wabash LLC*, No. 1-03-0751 (Ill. App. Dec. 24, 2003) (decision without published opinion), appeal denied, 809 N.E.2d 1287, (Ill. Sup. Ct. March 24, 2004), the court held that the intent of the parties is a prime factor in determining whether a sale-leaseback with an option to purchase is an equitable mortgage. The court refused to recharacterize the transaction where the seller-lessee could not satisfy its burden of proof that the parties actually intended a security agreement, and persuasive appraisal testimony indicated that fair value was given. See also *Robinson v. Builders Supply*, 223 Ill. App. 3d 1007, 1014-15 (1st Dist. 1992) (setting forth factors [including many of those listed above] and finding that “the record lacks conclusive evidence on the adequacy of consideration . . . and the value of the property”): *Hatchett v. W2X, Inc.*, 2013 IL App (1st) 121758, ¶ 39, 993 N.E.2d 944,

958 (“In determining whether an equitable mortgage exists, courts consider several factors, including a debt relationship; close relationship of the parties; prior unsuccessful attempts for loan; the lack of legal assistance; the inadequacy of consideration; an agreement to repurchase; and the continued exercise of ownership privileges and responsibilities by the seller”).

Recharacterization is always an uphill battle – the party seeking to recharacterize the transaction is trying to argue that something is not what the parties said it is. Courts aren’t particularly fond of these cases; they are equitable proceedings and courts generally will hold the party seeking to recharacterize the document or transaction to a high standard of proof. The question of valuation of the property often is crucial. For example, in *U.S. Bank N.A. v. Nielsen Enterprises, Inc.*, 232 F.Supp. 2d 500, 529 (D. Md. 2002), the plaintiff, a non-signatory leasehold lender who was attempting to alter the terms of an agreement to which it was not a direct party, sought to have a ground lease transaction (not involving an option) recharacterized as an equitable



mortgage. The court refused to recharacterize the transaction, finding that: 1) the landlord had not received a windfall because the discrepancy between the value of the land conveyed to the landlord and the and landlord's consideration was too small to be considered unfair or unjust; 2) the transaction was between sophisticated parties; 3) although the transaction had characteristics of both a land sale and a loan, there was sufficient evidence that it was a true sale to the landlord and not just a security device; 4), there was no right to prepay; 5) the leasehold lender had full access to the transaction documents prior to the closing and raised no objection; and, 6) the leasehold lender's failure to perform proper due diligence and its haphazard acceptance of income predictions created its predicament.

But other courts (especially in connection with bankruptcy proceedings involving the seller-lessee) have found, based on the facts of the case, that a purported sale-leaseback should be recharacterized as a mortgage. For example, In re PCH Associates, 949 F. 2d 585, 603-04 (2d Cir. 1991), the court held that based on the substance as opposed the form of the transaction, which had been characterized by the parties as a sale-leaseback but which actually had all the economic features of a mortgage-financing transaction with the purchaser-lessor bearing few if any of the risks of ownership, the transaction was not a lease under § 365 of the Bankruptcy Code and the deed given to the purchaser-lessor was not an absolute deed but was instead an equitable mortgage. See also In re Big Buck Brewery & Steakhouse, Inc., 2005 WL 1320165 (Bankr. E.D. Mich., June 2, 2005), at *11-12 (finding that property sale and ground leaseback transaction was a disguised financing agreement and not a bona fide lease under § 365 because seller-lessee retained all the risks and rewards associated with ownership of the property, and parties' intent would be discerned from totality of the circumstances).

FEDERAL TAX RECHARACTERIZATION

The Internal Revenue Service, when characterizing a transaction for tax purposes, considers the substance of the transaction, rather than its legal form, as controlling. Whether a transaction is a sale or a lease for income tax purposes is a question of fact, and depends on the intent of the parties as gathered from all the facts and circumstances, and whether the benefits and burdens of ownership have passed to the purported purchaser. See, e.g., IRS Field Service Advisory, FSA 199920003, 1999 WL 319513 (I.R.S.) (May 21,1999) ("Where there is a genuine multi-party transaction with economic substance that is compelled or encouraged by business realities, contains tax-independent considerations, and is not shaped solely by tax avoidance features, the government should honor the allocation of rights and duties effectuated by the parties"). See generally Shu-Yi Oei, Context Matters; The Recharacterization of Leases in Bankruptcy and Tax Law, 82 Am. Bankr. L.J. 635 (Fall, 2008).

BANKRUPTCY RECHARACTERIZATION

The lessor in a sale-leaseback transaction should be aware that if a bankruptcy petition is filed by or against the seller-lessee after the inception of the lease, the bankruptcy court may under certain circumstances recharacterize the lease as a financing transaction and limit the rights and remedies of the lessor to the value of its collateral as a secured creditor (assuming that the lessor is deemed to have a valid, perfected security interest). Certain provisions of the Bankruptcy Code ("Code") deal specifically with leasehold interests. Section 502(b)(6) of the Code, which limits the lessor's claim for damages against the debtor/lessee, does not define "lease of real property," as used in that section, but the legislative history makes clear that it applies only to a true or bona fide lease. S. Rep. No. 95-989,

at 64 (1978), reprinted in 1978 U.S. C.C.A.N. 5787, 5850. Section 365(a) provides that "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." Sections 365(d)(3) and (d)(4) of the Code, which delineate the rights of the bankruptcy trustee to assume or reject "any unexpired lease of nonresidential real property," apply only to true or bona fide leases.

The focus is on whether the parties intended to impose obligations and confer rights significantly different from those normally found in ordinary lease transactions. See, e.g., See, e.g., Barneys, Inc. v. Isetan Co. (In re Barney's, Inc.), 206 B.R. 328 (Bankr. S.D.N.Y. 1997). In this case the court held that whether an agreement constitutes a "true lease" for bankruptcy purposes must be determined by reference to federal law, and stated that the "[t]he appropriate inquiry is whether the parties intended to impose obligations and confer rights significantly different from those arising from the ordinary landlord/tenant relationship." Id. at 332. The court also noted that where the purported "lease" involves rental payments that are actually payments of principal and interest on a real estate loan, there is no "true" or "bona fide" lease and §§ 365(d)(3) and (d)(4), as well as § 502(b)(6), do not apply. See also In re Lefrak, 223 B.R. 431, 435 (Bankr. S.D.N.Y. 1998) (identifying other relevant factors in determining a true lease as (1) the length of the lease, and (2) whether the lease was part of a larger agreement).

Bankruptcy courts will closely examine the substance of the transaction, not the form, to determine whether it is an operating lease or a financing transaction and if the lessee is actually the beneficial owner of the property. They will disregard the characterization or label that the parties have used to describe the



agreement and the nature of their relationship, and will often employ an “economic realities test” to determine whether the transaction should be characterized as a true lease or as a financing transaction.

This test requires the court to determine whether “the parties intended to impose obligations and confer rights significantly different from those arising from the ordinary landlord/tenant relationship.” *Liona Corp. v. PCH Associates* (In re PCH Associates), 804 F.2d 193, 199-201 (2nd Cir. 1986). In *Steele v. Gebetsberger* (In re Fashion Optical, Ltd.), 653 F.2d 1385 (10th Cir. 1981), the court stated that, under the “economic realities” test, “where the terms of the lease and option to purchase are such that the only sensible course for the lessee at the end of the lease term is to exercise the option and become the owner of the goods, the lease was intended to create a security interest” (internal citation and quotations omitted) *Id.* at 1389.

CONCLUSION

The expressed intention of the parties still is one of the most important (if not the single most important) factor in determining whether a court will recharacterize a sale-leaseback transaction. Where the seller-lessee is a sophisticated and experienced real estate developer or investor and is represented by sophisticated legal counsel, and the documents negotiated and drafted by the parties (and their actions and conversations in connection therewith) expressly refer to the transaction as a sale-leaseback and make no mention, express or implied, of any other characterization (and in fact specifically disclaim any construction of the transaction as a security agreement or equitable mortgage, or any intention to create any relationship between the parties other than as expressly stated), the seller-lessee (or a bankruptcy trustee) likely will face an uphill battle in meeting its burden of proof that that transaction is something other than a sale-leaseback. The parties

must document the transaction carefully to avoid recharacterization, and the lease terms (including the rental) should reflect a true market lease and not a disguised financing transaction. Appraisal testimony (including the credibility of the individual appraiser) also can be crucial in determining the value of the property in these types of transactions, which in turn is crucial to the issue of whether the consideration for the transaction is fair and sufficient to prevent recharacterization.

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helped to revitalize and reinvigorate struggling centers. From luxury cinema experiences, to high-end bowling, golf and even indoor skydiving, entertainment is a popular and profitable proposition these days. Sports and fitness concepts are especially popular—dovetailing with a Millennial appreciation for a healthy and active lifestyle.

Empty anchors are well-suited for healthy and active concepts like fitness centers and rock-climbing facilities, and new activity-based entertainment concepts are proliferating. There is a social element to many outdoor and entertainment retailers, and brands are finding new ways to use their own space (as well as adjacent open green spaces) to capitalize on that. From yoga in the park, to hikes, gear tutorials and other special events, opportunities to provide consumers with even more experiential opportunities are becoming increasingly popular.

DINING AND DRINKING

New dining options and creative new bar, café and restaurant options are proliferating, filling space vacated by other retailers and creating a critical mass of restaurants that can greatly expand the local and regional appeal of a retail center. Chef-driven restaurants, farm-to-table concepts and local/independent operators are on the upswing, and the explosive growth of the fast-casual segment has

prompted the increase of new, and in many cases more premium fast-casual offerings. Food is arguably the driving force in retail development today, and some estimates project the amount of GLA devoted to it to increase by an eye-opening 150 percent in the next few years alone.

Dining is an inherently experiential process, and the activity and energy of outdoor dining, open kitchens and new and emerging creative concepts can add an enormous amount of value to a retail or mixed-use center.

TECHNOLOGY & TRANSITION

Millennials aren't the only ones who utilize technology as an integral part of their everyday lives. The near universal availability and adoption of tech conveniences and the growing power of social media platforms as an essential channel for marketing and communications means that retail and mixed-use projects that don't embrace technology are setting themselves up for failure.

Integrating more tech into the actual project itself—interactive touchscreen maps and navigation; changing billboards and signs; targeted and personalized promotions that pop up on a customer's phone when they walk into a store—not only makes the shopping experience more seamless and convenient, it does so

in a way that encourages shoppers to engage with the space around them. In the process, a passive experience becomes more active and experiential. At the same time, more retailers are experimenting with new ways to make the transition from online browsing and shopping to on-site pickup an easier and more efficient process.

COMMUNITY & CREATIVITY

The more a retail or mixed-use development can become connected with the surrounding community, the better its chances to flourish. Serving as a community resource for celebrations and special events is a great place to start. Open spaces and common areas can be used for weekend farmers' markets, and underutilized spaces can be made available for local entrepreneurs, seasonal vendors and pop-up shops. Offering up gallery and studio spaces for local artists, musicians and designers is an excellent way to strengthen ties with the community and add some experiential flavor to a retail center.

As some retailers adapt and evolve successfully, and others fall by the wayside, these are the trends that are helping to redefine the nature of retail and influence the future of commercial real estate.

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NAIOP—Commercial Real Estate Development Association
CRE.Converge 2017
www.naiop.org
October 10 – 12 • Chicago, Illinois

PREA—Pension Real Estate Association
27th Annual Institutional Investor Real Estate Conference
www.prea.org
October 16 – 18 • Chicago, Illinois

MBA—Mortgage Bankers Association
Annual Convention & Expo
www.mba.org
October 22 – 25 • Denver, Colorado

ULI—Urban Land Institute
ULI Fall Meeting
www.uli.org
October 23 – 26 • Los Angeles, California

CREW—Commercial Real Estate Women
CREW Network Convention & Marketplace
www.crewnetwork.org
October 25 – 27 • Houston, Texas

ICSC—International Council of Shopping Centers
US Shopping Center Law Conference
www.icsc.org
October 25 – 28 • San Antonio, Texas

The Lodging Conference
www.lodgingconference.com
October 30 – November 2 • Phoenix, Arizona

CoreNet Global—Corporate Real Estate Network
CoreNet Global Summit - North America
www.corenetglobal.org
November 5 – 7 • Seattle, Washington

NAREIT—National Association of Real Estate Investment Trusts
REITWorld: NAREIT's Annual Convention for All Things REIT
www.reit.com
November 14 – 16 • Dallas, Texas

