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DLA PIPER

REAL ESTATE GAZETTE

FOCUS ON: SPECIALIZED ASSETS

ANTICIPATING CHANGING TRENDS IN DISTINCT ASSET CLASSES WITHIN THE REAL ESTATE SECTOR

ISSUE 22

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A NOTE FROM THE EDITOR

The twenty-second issue of the DLA Piper Real Estate Gazette highlights issues relating to specialized asset classes.

A very warm welcome to Issue 22 of DLA Piper's *Real Estate Gazette*.

The reputation of DLA Piper's real estate group for offering leading legal services across Europe and beyond has been built on the twin foundations of global coverage and a sector approach to real estate. As part of our aim of providing innovative and dynamic services for our clients, we are constantly monitoring new developments and anticipating changing trends in the real estate sector as a whole and, in particular, in the distinct asset classes within the sector that require specialist knowledge and expertise.

It is clear that demographics play a part in dictating which investment opportunities are prominent at any point in time. For example, in France, the rise in student numbers has boosted demand for student accommodation in the country, and this fact, combined with the various advantages enjoyed by this asset class (see page 10), look set to attract a wide number of investors looking for diversification towards contra-cyclic products. Another demographic often noted is the increased proportion of those aged over 65, estimated to constitute 16.2 per cent of the global population by 2050. This will undoubtedly lead to a higher demand for long term care services. In China, the current supply of senior housing is minimal, forcing the Chinese government to take steps to actively encourage domestic and foreign investment in senior housing (page 6). In Italy, the provision of long term care services is also changing with family-run providers being forced out of the market by tighter regulation and new entrants being attracted by the relative stability of cash flows and the profitability of the initiatives (see page 12). Other developments discussed include the rise of the local accommodation establishment in Portugal (page 16); the controversy surrounding art as an asset class in the UK (page 20); and the qualification of certain real estate assets for REIT purposes in the US (page 22).

In other articles, our contributors examine the usual diverse range of topics, reviewing proposals for a new Construction Code in Poland (page 26) and the principle of good faith in lease negotiations in Russia (page 28), amongst other areas of interest in global real estate.

We do hope that you will enjoy reading our views.

Olaf Schmidt, Head of International Real Estate

> "Demographics play a part in dictating which investment opportunities are prominent at any point in time."

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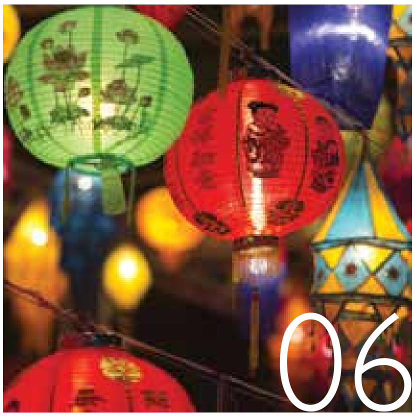

SPECIALIZED ASSETS

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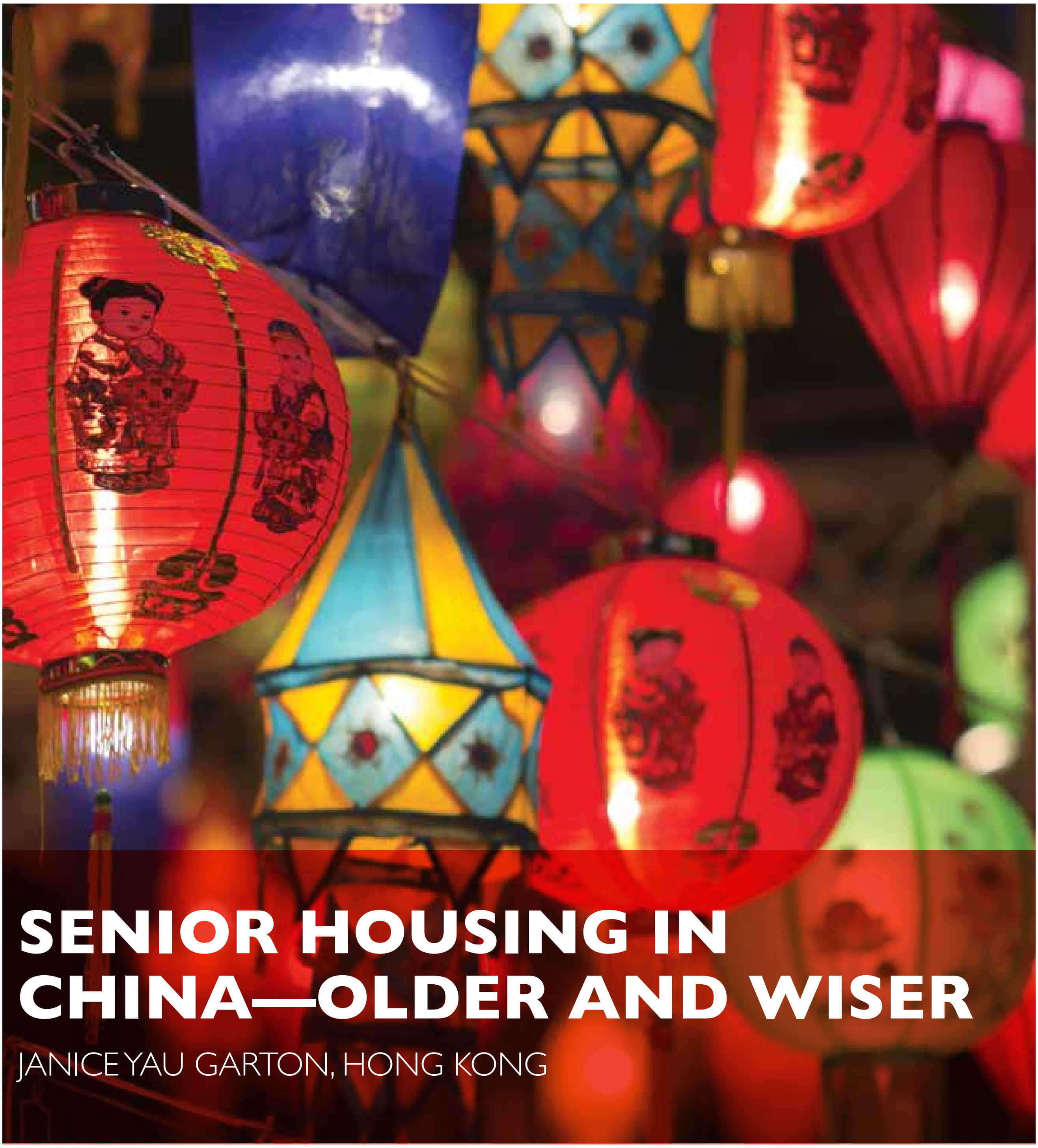


SENIOR HOUSING IN CHINA—OLDER AND WISER

JANICE YAU GARTON, HONG KONG

In Issue 7 of the DLA Piper *Real Estate Gazette* (Winter 2012) (page 6) we outlined how China wants to encourage investment in senior housing as it tackles a looming demographic crisis, offering tax incentives and other benefits to attract foreign investors.

After almost four decades of its single-child policy, China is facing a shortage of families able to care for their elderly relatives. The annual birth rate has fallen from 18.2 per 1,000 people in 1980 to 12.9 in 2015, according to the World Bank.

At the same time, people are living longer. China's 220 million people over 60 now represent 16.3 per cent of its total population, up from 10.3 per cent in 2000. By 2020, that number will reach 248 million, equivalent to the current total population of Germany, France and the UK combined. By 2050, China will have 437 million people over 60, more than the total projected population of the US.

The current supply of senior housing units in China is minimal, and most are provided by the government. By some estimates, in 2012 there were facilities for only 1 million in all of China—covering less than 0.5 per cent of the 220 million aged population. That contrasts to the US, where 7 per cent of the population over 55 lives in senior housing.

Clearly, there is a significant gap between demand and supply. From a construction perspective, estimates suggest China will need another 4.0–5.2 million elderly beds by 2020, equal to around 100–182 million sq. m.

State encouragement

The Chinese government, always sensitive to issues that may contribute to a breakdown in social harmony, is encouraging domestic and foreign investment in senior housing. This has led to the Law on the Protection of the Rights and Interests of the Aged, which has introduced various preferential policies regarding electricity, land and taxation designed to support the further creation of social welfare institutions for the aged. Reverse mortgages (also known as "equity release") are now allowed, and basic pensions and old age allowances are coming into force.

Significantly, the 2015 update to China's Catalogue for the Guidance of Foreign Investment Industries classifies elderly care institutions (ECIs) as an "encouraged" sector. That means the Chinese government is actively seeking foreign investments in this sector, and allows foreign investors to operate through a wholly foreign owned entity (WFOE), rather than through a joint venture, as required for most real estate assets. Foreign investors are able to enjoy certain benefits such as tax incentives, cheaper land costs, simplified approval procedures and other beneficial investment terms for their investment in this sector.

In practice, however, foreign investors may be restricted in running a senior housing business in some locations. For example, at the time of writing, Shanghai requires foreign investors to approach the market through a Chinese–foreign joint venture, even though ECIs can be established as WFOEs in the Shanghai Free Trade Zone.

Incentives

Land use rights have been strengthened, but foreign investors still face numerous restrictions in developing land in China. For example, foreign investors cannot apply for a permit to operate an ECI until a completed premises has been secured. Therefore, unlike the logistics industry, where foreign investors can acquire and develop land for self-use, it is almost impossible for a foreign-invested ECI to engage in land acquisition and development.

The most recent guidance on land use closes some of the loopholes in the elderly care industry. In the past, private and foreign investors have relied on the provision of elderly care services as a way to develop real estate projects. To ensure that the approved ECI is actually used for its intended purpose, restrictions on the construction area for each living room are put in place (limited to 40 sq. m), and local governments are not permitted to approve any subsequent changes in land use zoning or floor space ratios.

Foreign invested ECIs will enjoy the same preferential treatment granted to domestic private ECIs, including exemption from, or reduction of, taxes and administrative charges.

All fees regarding electricity, water and gas should be charged in accordance with that charged to residences, and local authorities are encouraged to provide discounts on administrative levies.

Elderly care services provided by private owners are exempted from business tax, and the transfer of building ownership or land use rights during the restructuring of an ECI is exempt from value added tax and business tax.

Local governments must also direct a portion of their funds to elderly care. The Ministry of Civil Affairs and the local government must use more than 50 per cent (60 per cent for Shanghai) of the welfare fund collected through the sale of lotteries for elderly care business and must raise the percentage incrementally as the elderly population increases. Among the funds to be dispensed, those allocated for the promotion of private investment must not be less than 30 per cent. The funds may also be used to support private elderly care projects.

Structuring

Despite the elderly care sector being encouraged in the Catalogue for the Guidance of Foreign Investment Industries, foreign investors will still need to enter into a Chinese–foreign joint venture to obtain the required permit in some locations.

Foreign investors may choose to approach the elderly care market through the following models:

- **Foreign-invested real estate enterprise**
  Foreign investors may participate in senior housing as a real estate enterprise especially during the early development stage. There is no restriction on foreign-invested real estate enterprises obtaining land use rights for undeveloped land. Once the development is completed, the ECI can be leased to a third-party operator. If, however, the foreign-invested enterprise would like to operate the ECI business itself, it will have to expand its business scope and obtain the requisite permit and authorization.
- **Foreign-invested ECI**
  As the sector is encouraged in the Catalogue for the Guidance of Foreign Investment Industries, foreign investors may establish a Chinese–foreign joint venture ECI. Investors may choose to outsource the operation of the ECI to an experienced operator, or hire employees to operate the ECI on its own.
- **Joint venture with insurance institutions**
  Insurance institutions benefit from state support for investments in medical institutions and the elderly care sector. Taking advantage of upstream health insurance, maintenance insurance and elderly care insurance, sufficient capital and client resource could promote the development of downstream senior housing industry and make such development sustainable.
- **Public private partnership**
  Just this year, the Ministry of Civil Affairs pledged to support the participation of private investors (including foreign investors) in the development of elderly care services through the public–private partnership model. The Ministry has also encouraged the build-operate-transfer (BOT) model, while public sector ECIs are encouraged to involve the private sector by way of contracting, associated operations, equity joint ventures and general cooperation. Where appropriate, governmental agencies are also encouraged to procure services from private elderly care service providers, and public enterprises are being encouraged to convert their resorts, training facilities, hostels and nursing homes into elderly care service agencies.
- **Franchises**
  Foreign investors are also encouraged to scale up elderly care investment, develop franchises and cultivate quality elderly care brands in China. Additionally, they are allowed to participate in the privatization and restructuring of public ECIs. So far, few regulations can be referred to in detail.

The long and winding road

Having long been dominated by publicly-run institutions yet significantly underfunded, the Chinese government's recent legislative moves present a significant opportunity for private and foreign investors in the senior housing market in China. Although a wide range of supportive rules and regulations have recently been issued, foreign investors will need to navigate these new policy changes very carefully.

SOCIAL HOUSING IN DENMARK

MICHAEL NEUMANN, HORTEN, COPENHAGEN

Introduction

The social housing sector in Denmark has recently been the focus of increased attention, following amendments to the Danish Planning Act. This sector has continued to grow and is now a fundamental part of the Danish approach to welfare. However, as this article will discuss, the changes to the Danish Planning Act could give investors in Danish real estate pause for thought, especially if they plan to build in areas which are not yet used for residential purposes.

The concept of social housing

Social housing in Denmark is based on a simple philosophy: affordable and decent housing for people in need. Consequently, the social housing sector is divided into three categories: housing for the elderly, housing for the young and housing for families. The residents of social housing are tenants and thus they do not own the property or hold a right of use over the property. This differentiates social homes from homes that are jointly owned with housing associations and those which are owner-occupied.

The Danish government provides financial support to housing associations, meaning that the tenants pay a relatively low rent. Consequently, there are long waiting lists for social homes and it has become almost common practice for parents to put the names of their newborn children on the waiting lists for various housing associations. This is especially the case in the main towns, since it is almost impossible for students, for example, to get an apartment in the Greater Copenhagen Area with an affordable rent.

In recent years, the social housing sector has played a significant role in developing new housing estates in which the main focus has been increased diversity. One consequence of this is that social homes are now being built alongside high end investment projects for private residents.

Background

Today, there are around 700 housing associations in total. These associations aim to build, rent out, manage, maintain and refurbish homes within the social housing sector. There are no restrictions as to who can sign up for and obtain such homes, although an applicant must be at least 15 years old. Consequently, housing associations help to house many of those from underprivileged groups in Danish society.

The social housing tradition dates back more than a hundred years, and the sector gained increased prominence after the Second World War with the establishment of the Danish welfare state. Before that, it was mostly pioneers and philanthropists who focused on the need for social housing. However, since the Second World War, the number of social housing units has continued to rise despite the variations in the level of interest in the sector with the various changes in government. Today, there are around 560,000 homes within the social housing category in Denmark, meaning that around every fifth home is within the social housing sector.

The increased focus on this sector has been followed by legislation, which is quite strict. The sector is regulated by the Social Housing Act (*Almenboligloven*) 1996, which is primarily concerned with the setting up of housing associations and tenants' rights and obligations. The other

> “The changes may influence the market price of sites which are not already used for residential purposes.”

main piece of legislation is the Social Housing Rent Act (*Almenlejeloven*) 1997, which governs the relationship between housing associations and tenants.

Change to the Planning Act

The latest boost to the social housing sector came with changes to the Danish Planning Act in March 2015. As a result of these changes, it is now possible for local authorities to require that up to 25 per cent of the housing stock in an area be reserved for social housing units when drafting a district plan. The term "housing stock" is not defined and it will thus be for the local authorities to decide the scale of the total housing stock.

The "25 per cent rule", as it is now called informally, applies to both public and private land, though only to areas which are not already used for residential purposes. Likewise, the rule does not apply to areas already laid out in a district plan for residential use. Consequently, this rule can only come into effect for areas without a district plan or areas that are currently laid out for commercial or public purposes.

However, a decision by local authorities that the use of property must be changed to residential purposes is similar to a situation of compulsory purchase. Consequently, and as with compulsory purchase, such a decision may entitle the owner of the property to claim that the authority has taken possession of the property and is thus required to compensate the owner in full. However, a claim is conditional on the owner proving that he cannot reasonably use the rest of the property independently. As a general rule, the more the authority's decision is in the nature of a compulsory purchase, the better the landowner's chances of forcing the authority to take possession of the property. This would be the case particularly where the authority is not able to give financial support to the owner, or it is not possible to find a housing association that is willing to buy the property.

It should be noted that the changes to the Planning Act do not have any effect on the ability of local authorities and landowners to voluntarily enter into agreements for the establishment of social housing units.

Consequences for landowners and investors

The changes may influence the market price of sites which are not already used for residential purposes or laid out in a district plan as such. Further, there are fears that the rule change will deter investors from investing in an existing property which is not used or laid out for residential use, since it is possible in those circumstances for the council to apply the rule on properties not currently used for residential purposes, as described earlier. This may have a particularly severe effect in the big cities, with, for example, Copenhagen already estimating that the possibility of planning subject to the new rule will result in 2,800 social housing units between now and 2025.

In conclusion, it cannot be ruled out that the changes to the Planning Act will have an adverse effect on investment in sites or properties which are not already used for residential purposes. It remains to be seen how the courts will apply these rules. Finally, it should be noted that the new rules are being introduced for a 10-year trial period and will be reviewed in 2024–25.

STUDENT HOUSING AS A DISTINCT ASSET CLASS IN FRANCE

ANTOINE MERCIER, PARIS

At a time when the student population is rising by around 1.5 per cent each year in France—this figure including an increasing number of overseas students attracted by recent amendments to immigration laws and cheap tuition—the need for special housing has escalated substantially over the last five years. France has now become one of the most desirable study destinations in the world according to a recent survey undertaken by Savills Estate Agents. At the same time, although the country's capacity to house students has increased, it remains insufficient, meeting less than 15 per cent of students' accommodation needs.

Although those currently investing in student accommodation are mostly investors dedicated to this particular asset class, when one considers the unprecedented mix of the scarcity of accommodation available and the increasing demand for it, combined with yields in the higher range of real estate investment (between 5.3 and 6.7 per cent, according to Savills), and the appetite for long-term revenue with low risk of borrowers defaulting (since students' parents often act as guarantors and the French state grants large subsidies), it is likely that different types of investors, looking for diversification towards contra-cyclic products, will be attracted to the student accommodation market.

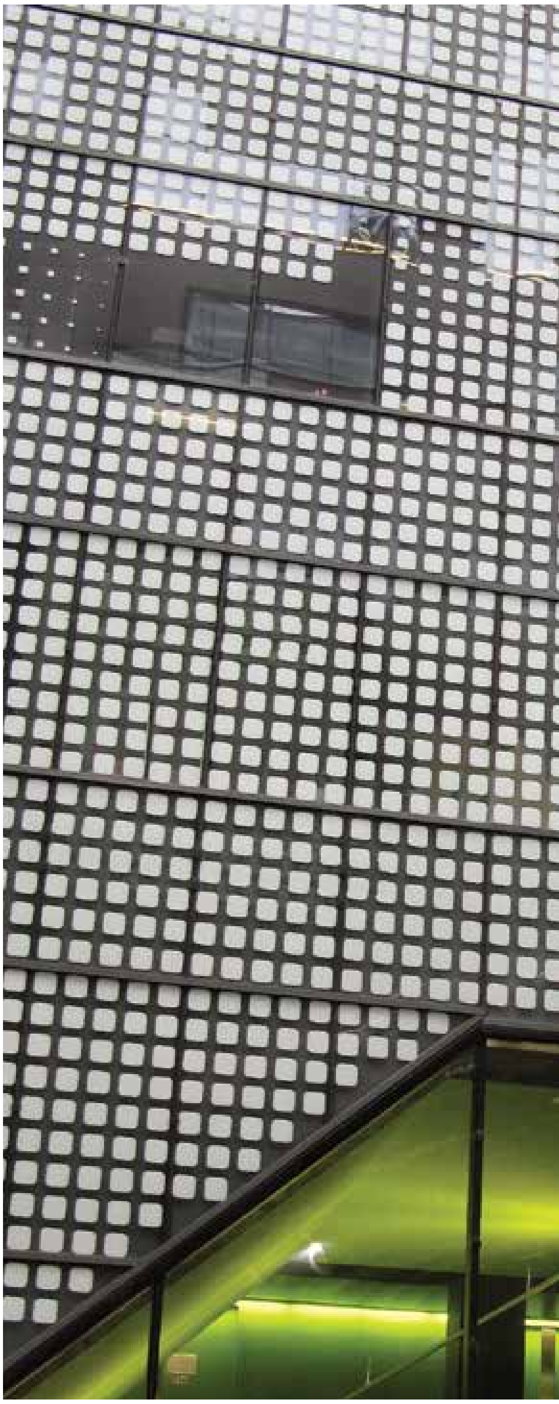
This class of real estate assets developed in France on the back of other previously regulated classes of assets such as hotels and residential units, which now exhibit serious drawbacks in terms of duration of leases, rent review or recovery of service charges. However, student accommodation is now regulated separately by the new ALUR (*l'accès au logement et un urbanisme rénové*) law of 24 March 2014 as falling within the category of university residences (*résidences universitaires*), and benefits from certain advantages in comparison with other classes of residential assets. The remainder of this article will examine those advantages.

More flexible lease term

Following the enactment of the ALUR law, student housing falls within the same category as residential units, provided the premises constitute the main residence of the occupier, whether the premises are furnished or not. The premises are deemed to be a main residence provided they are occupied for at least eight months of the year. This means that some of the measures intended to protect tenants in residential premises will apply. However, certain exceptions exist, such as provisions for the lease term to be as short as one day if the tenant is a student, instead of the mandatory minimum three-year term (or six years when the landlord is not a private individual). Furthermore the lease will not renew automatically and the landlord is entitled not to renew without cause, which provides a certain flexibility, for example, if the investor needs to use the summer holiday period to carry out refurbishments.

No cap on rent increases

Another exception arises if the premises are furnished and operated under a commercial lease (ie the owner of the property grants a lease to the operating company) and certain services are rendered to students. In this case the rents are not capped even where the premises are located in one of the zones designated by the ALUR law as being one in which the lack of properties available



> "Student houses may fall within the category of social housing, provided they are let to students from economically disadvantaged backgrounds."

for rent is high and accordingly subject to a rent cap. This of course has the effect of netting higher returns for the investor.

Recovery of higher proportion of service charges

In the circumstances outlined above of an intermediary lease with services ancillary to it, the service charges are recoverable as a freely set lump sum and not capped to the costs effectively recoverable from tenants as set out under the ALUR law. However, the landlord must still ensure that the lump sum payable remains in line with the costs and expenses actually borne by the landlord.

Use of quotas relating to social housing

Most of the local planning schemes in France's major cities impose construction quotas for social housing units in development projects involving residential premises. The letting of these units must be on conditions significantly more beneficial to the tenant. Since this quota is often up to 20 per cent of the residential development as a whole, these constraints can have a deterrent effect on developers and investors.

By inserting new provisions in the Construction Code, the ALUR law has provided that student houses may fall within the category of social housing, provided they are let to students from economically disadvantaged backgrounds. This means the development plan meets the criteria of social housing, allowing investors not only to overcome the initial challenge of having to develop social housing, but also giving them the opportunity to develop an alternative asset class within a less competitive and fast growing market.

LONG TERM CARE—A SAFE BET FOR INVESTORS

VITO BISCEGLIE, ROME

Long term care in Italy: looking ahead

The structure of the world's population is undergoing significant change. The Organisation for Economic Co-operation and Development (OECD) forecasts that globally the proportion of those aged over 65 in the population will more than double to 16.2 per cent by 2050, with the percentage of people aged 80 and over trebling.

At the same time, in Italy, as in the rest of Europe, the requirements for health and social care services, and the connected public and private costs, will increase exponentially, especially as regards long term care services. The latest report from Italy's Ministry of Economy and Finance (RGS) notes a health and social care services bill constituting 1.9 per cent of Italian GDP in 2010 (around 33 billion euros) that is estimated to reach 3.3 per cent of GDP by 2060. Between 2007 and 2013 the public expenditure on health care services did not increase (principally because of the financial crisis), however, private expenditure in this area more than doubled.

Italy is in a unique position among its European neighbours, given the strong involvement of family members in care provision. Informal and home-based care provided by caregivers or relatives has historically prevented significant growth in the formal institutional care market. However, increased female participation in the workforce combined with low fertility rates and the new policy of medical assistance in hospitals (where, more and more, only those with serious illnesses are assisted), have begun to change the traditional model.

In the area of services for the elderly (ie nursing homes providing long term care) the 2013 report by ISTAT (the National Public Institute of Statistics) notes that Italy has a significantly lower number of beds than in other countries and this limited development, coupled with excessive demand, has had a positive impact on occupancy rates, which range between 93 and 98 per cent for the majority of care homes.

Further, the top five private operators account for a relatively small number of those beds: the Italian care market has avoided consolidation, with the market still dominated by independent operators with one or two facilities. This is not the case in other countries, where the market has seen significant consolidation: in France and Germany the top three and five operators respectively manage a significant number of the beds available.

The regulatory system

Following the 2001 reform of Title V of the Italian Constitution, the Italian health care system is now divided between the state and the regions, both having regulatory power in some areas. As a result, Italian health legislation varies from region to region, despite the government's attempts to establish the essential principles with national legislation, in order to coordinate and supervise services, and to guarantee an equal level of health care provision for all citizens throughout the country.

Regardless of the variation in the different regional regulations, the current system of health care provision is typified by a very high level of regulation, both in qualitative and quantitative terms. Certain requirements must be met, specifically: (a) structural requirements, related to the characteristics of the building where services are provided, (b) organizational requirements, related to the number of personnel and their qualifications and (c) technological requirements, related to the presence of specific technological equipment. Compliance with the numerous regulatory requirements is a prerequisite for obtaining and maintaining the administrative authorization which allows providers to offer health care services with the costs borne by both users and the National Health Service.

Effect of higher levels of regulation on market participants

The considerable level of fragmentation means that there is substantial room for new entrants and potentially greater consolidation of private homes. The very small, small and medium sized independent facilities (on which the system was founded) are now in crisis due to the higher levels of regulation noted above. Such facilities are often typified by a family run management and it is thus very difficult for them to build economies of scale.

Against this background, we are witnessing a revolution in the provision of care services, with only those who have reached a high level of professionalism able to maintain the levels of competitiveness and profitability that allow them to stay in the market.

Innovative financial schemes

Because of the huge costs connected to the construction and/or the acquisition of the buildings where services are provided, the use of innovative financial schemes is becoming essential.

The twin phenomena of growth and the increasing need for operators' professionalism allow for the development of economies of scale that ensure both the economic sustainability of the system and a level of competitiveness and profitability that boosts return on investment.

As a result, interest from investors in this asset class has increased, further enhanced by the relative stability of cash flows and the profitability of the initiatives. A few years ago, investors making a foray into this sector for the first time were rare and, notably, not based on an analysis and risk assessment approach specific to the sector (but rather on a purely traditional approach to real estate assets). Currently, however, models of structured collaboration between investors and professional operators are emerging.

In this scheme of cooperation, the operator has a precise scouting role as regards possible investment opportunities and the subsequent management of the facilities acquired. In the leasing agreements (to be entered into between the investor and the operator) the parties agree to rules of governance, rights of exit, compensation schemes, information flows and collateral in the event of default by the operator.

It is easy to envisage a model similar to the one developed in the hospitality industry emerging: this model has, in fact, encouraged the entry into the Italian market of foreign investors focused on purchasing the real estate component of hotels, the management of which is then entrusted to large dedicated companies.

In addition, any risk still perceived by investors can now be further mitigated by the fact that the health care sector features systems of monitoring and accountability that guarantee a high quantity and quality of information, covering the level and quality of services provided, needs, and operators' performances.

“The very small, small and medium sized independent facilities (on which the system was founded) are now in crisis due to the higher levels of regulation.”

HIGH TECH REAL ESTATE—THE FUTURE LOOKS BRIGHT FOR DATA CENTERS IN NORWAY

MAGNUS LØVLIEN LUTNÆS AND OLA RUNDFLOEN, OSLO

With its cold climate and easily accessible renewable energy, Scandinavia is rapidly becoming a hotspot for large scale international data center (DC) projects. In the town of Hamina in Finland, Google has established one of the most advanced and efficient DC facilities in the Google portfolio on the premises of a 60-year-old pulp mill. When Facebook looked at over 100 potential locations in Europe for its first DC facility outside of the US, Luleå in Sweden, a small town just 100km south of the Arctic Circle, ended up as the preferred choice. And just last year, Apple announced that Jutland in Denmark was to be a part of Apple's EUR 1.7 billion investment in two new European DCs.

It can be seen then that in the last few years, the region has attracted several of the world's leading IT companies. In addition, the region has also seen increased activity among its regional and local market participants. Based on current trends, this real estate niche looks set to experience more growth in the future.

From the Norwegian real estate perspective, there appears to be no reason why Norway should not be the prime location for large scale DC activities in Europe. The country has very sympathetic climate conditions for environmental cooling, abundant clean power resources, a good grid and energy infrastructure, large available land areas and a competent work force within both the real estate and IT sectors. So why is it then that Norway has missed out on the likes of Apple and Facebook so far?

One of the main reasons is Norway's tax position on energy consumption. Based on the current tax regime, Apple would actually pay less for clean Norwegian hydro power exported to and used in Denmark than they would

pay for the exact same hydro power if it was used in Norway directly. This has led many companies to conclude that settling outside Norway would be more profitable. This should come as no surprise when one considers how energy-intensive DC activities are, and how even a small change in energy prices can have a big impact on expected profitability.

Luckily for the Norwegian DC market, a change for the better is expected in the very near future.

Until now, DCs in Norway have been classified as a service industry for tax purposes. As a consequence, they have been subject to the general energy tax rate on energy consumption. This rate was recently adjusted to NOK 0.1415 per kWh from 1 July 2015 (NOK 1 is approximately EUR 0.11).

> "If the proposed changes are approved, Norway will be firmly in the driving seat in the Nordic region when it comes to tax on energy usage for DC activities."

Traditional production industries, on the other hand, have been subject to a reduced energy tax rate of only NOK 0.0045 per kWh. Especially energy-intensive industries focusing on chemical reduction, electrolysis and metallurgy, for example, have not been subject to any tax liability on their energy consumption. When operating a large scale DC at full capacity, low energy tax rates make a big difference.

In the revised national budget for 2015, the Norwegian government proposed a reduction in the energy tax to be paid by large DCs, effective from 1 January 2016. This was followed by a statement in the proposed national budget for 2016 that large DCs are to be subject to the same reduced tax rate applicable to traditional production industries. In the light of Norway's currently weak currency, the reduced tax rate of NOK 0.0048 per kWh has been suggested.

Current political indications are that only large DCs (a term which has yet to be expressly defined) with a capacity of over 5 MW, and who mainly operate with data storage and not data processing services, will be able to take advantage of the reduced tax rate. Nevertheless, the proposal represents a major commercial improvement for anyone currently operating a large DC in Norway, or anyone considering Norway as a location for their next large DC facility.

Going forward, the Ministry of Finance and the Ministry of Trade, Industry and Fisheries will work together to ensure the proposed changes will be approved by the relevant authorities in the EU. Norway, although not a member of the EU, is a still a member of the European Common Market and follows all EU directives. However, since the Finnish model allowing DCs with an energy consumption above 5MW to pay a reduced rate of tax has already been approved by the EU, it seems likely that the new Norwegian tax policy will be similarly approved.

Compared to the Nordic countries close to Norway, a tax rate of NOK 0.0048 per kWh is very competitive. To put it into perspective, it may be noted that Denmark has a reduced tax rate on all production processes of approximately NOK 0.005 per kWh, while heating and cooling are subject to a somewhat higher rate. Finland has a tax rate of approximately NOK 0.065 per kWh for DC energy usage. In Sweden, DCs are subject to the standard rate of approximately NOK 0.29 per kWh, with the exception of the northern part of the country where the tax rate is lower at roughly NOK 0.18 per kWh.

Thus if the proposed changes are approved by the Norwegian parliament later this year, and provided they comply with the relevant EU notification procedures, Norway will be firmly in the driving seat in the Nordic region when it comes to tax on energy usage for DC activities. It is anticipated that this change will result in increased market activity and the initiation of new projects. From a wider perspective, the change will also underline the great inherent potential for profitable DC facilities in both Norway and the Nordic region in general.

LEGAL FRAMEWORK FOR GUESTHOUSES AND HOSTELS IN PORTUGAL

LUÍS FILIPE CARVALHO AND MARISA MIRADOR,
ABBC LAW FIRM, LISBON

The category of local accommodation establishment (LAE) was created in 2008, when new legal provisions governing businesses relating to tourism, including hotels, were enacted. This new category was introduced in order to allow accommodation that did not meet the new legal requirements to continue offering accommodation to tourists, as well as to provide regulation for the increasing proportion of "informal" tourist accommodation being offered.

It soon became clear that this was not a temporary phenomenon, but rather, an ongoing global trend, as similar examples of such tourist accommodation continued to proliferate. To some extent, this trend was reinforced by the housing market crisis which has contributed to the attractive prices, bespoke character and privileged sites—normally prime city locations—of such accommodation.

The problem was that the number of what have become known as "illegal beds" increased alongside the genuine LAEs, facilitated by various holiday rental websites. For example, in 2013 it was estimated that there were four million informal overnight stays, representing 10 per cent of the total number of short stays, and as a consequence, lost tax revenue of approximately EUR 40 million.

In response, the Government enacted Decree-Law No. 128/2014, as amended by Decree-Law No. 63/2015, creating a special framework for LAEs. These are defined in the legislation as temporary accommodation services for tourists, offered for a fee and meeting the relevant legal requirements. This status is expressly prohibited to those establishments that already meet the requirements to be considered businesses relating to tourism, such as hotels.

This new regime intends to simplify the operation of, and promote access to, this type of accommodation but, at the same time, to create more effective control mechanisms, in particular to combat non-compliance with tax obligations (for example, by introducing the mandatory exchange of information between local authorities, the Tourism of Portugal Institute and Portugal's tax authority). For the purpose of promoting LAE activity, the operation of an LAE is not subject to licensing or to payment of fees, but rather to a simple registration procedure by prior notification. This can be done electronically. Nevertheless, the competent local authority will inspect the premises within 30 days after notification.

Under the legal framework, there are three categories of LAE, depending on

> "The development of LAEs is one of the most successful new trends in the main cities in Portugal."

the type of accommodation unit: houses (consisting of family accommodation), apartments (consisting of a separate part of a building or urban property with independent use) and hosting facilities (consisting of rooms only). The last category includes hostels (consisting mainly of dormitories). All categories of LAE have to comply with basic requirements relating to hygiene, fire safety, ventilation, sanitary facilities, privacy, supply of water and sanitation. Hostels must meet the additional requirements of a minimum of four beds per dormitory (or a lower number if they are bunk beds), and provision of specific social and common areas. In hostels (and in hosting facilities) the setting-up of ancillary commercial and services businesses, for instance the provision of food and beverages, is permitted.

The maximum capacity of an LAE, with the exception of hostels, is nine rooms and 30 users, and the same operator (which includes different companies with common shareholders) is prohibited from operating more than nine apartments per building if that exceeds 75 per cent of the total number of apartments.

For advertising and marketing purposes, LAEs are required to show their name or logo and registration number. They cannot suggest features that the establishments do not possess or that they are integrated into larger tourism enterprises. Also, an establishment is only permitted to call itself a "hostel" where its predominant accommodation unit is the dormitory. This requirement is considered to be met when the number of visitors staying in dormitories is higher than the number of visitors staying in individual rooms.

The development of LAEs is one of the most successful new trends in the main cities in Portugal, with the total number of registrations—currently around 17,000—increasing since the new legal framework was approved. This may be considered to be a new area of opportunity, requiring low investment in terms of facilities and compliance, as the establishments are not subject to the rules and regulations applying to hotels and other types of traditional tourism accommodation (on which, see Luís Filipe Carvalho and João Fitas, "International Investment in Portugal's Hospitality Industry" *Real Estate Gazette* (2015, Issue 21) page 27 (hard copy), page 40 (z-mag)). Expectations for LAEs are high, especially as Portugal was one of the top three European countries in terms of tourism growth in 2014, with new highs predicted for 2015.

ABBC is DLA Piper's Focus Firm in Portugal.

ASSET OR GOING CONCERN? MANAGEMENT IS THE KEY

INES CHAMARRO AND IGNACIO CACHO, MADRID

The real estate sector in Spain suffered a severe downturn in the financial crisis but it is now being reborn from the ashes like a triumphant phoenix. The last couple of years have seen a significant rise in investor interest, marked by the entry of new players, including Spanish SOCIMIs (for details of which see Orson Alcocer, "SOCIMIS—At Last REITs in Spain", *Real Estate Gazette*, Issue 15, page 38 (hard copy), page 70 (z-mag)) as well as new foreign investment funds. In this revived market, shopping malls and hotels, as particular types of real estate investment, share some helpful and potentially unhelpful characteristics that need to be considered, when they are the target of these new investments. Acquiring these assets is not always straightforward and there are some taxation pitfalls which should be avoided.

Assets in these classes may be acquired through an asset deal or through a share deal. It is when the acquisition is structured as an asset deal that the difficult issue of asset versus going concern may be encountered.

To understand the significance of this issue, it should be noted that the Spanish tax regime applicable to the acquisition of a real estate asset is radically different to that applying to the acquisition of a going concern for the following reasons:

- In the case of an acquisition of an asset, and provided that both parties are subject to VAT, the acquisition is subject to VAT and stamp duty. This type of transaction is highly advantageous for tax purposes since, as a general rule, VAT incurred in the acquisition of non-residential real estate is immediately recoverable through what is known as the reverse charge mechanism. Under this procedure, the tax is levied but instantly deducted, so that no cash changes hands. Therefore, effectively, the only tax payable will be stamp duty. Stamp duty rates are regional and range between 0.5 and 1.5 per cent.
- The acquisition of a going concern is not subject to VAT but is instead liable to transfer tax on the real estate transferred within the going concern. Transfer tax is not recoverable in Spain, and so becomes an additional cost for the purchaser. The rates of this tax are also regional and range from 6 to 11 per cent, depending on the location of the asset.

It is evident then that an asset purchase offers great advantages, so it is important to be clear on the difference between an asset and a going concern, and also on how to be sure that the asset transfer will indeed be treated as an asset purchase rather than the transfer of a going concern.

The key element to the definition of going concern, in this case, is the business structure: does what is being sold

constitute a structure capable of carrying on an existing business activity?

It may be thought that the business of a shopping mall is retail sales, and that since this is carried out by the retailers and not by the owner of the shopping mall, it is clear that this must be an asset sale. However, that first instinct is wrong. The actual business activity of the shopping mall is not retail; it is the activity of leasing the stores to the retailers.

The same principle applies to hotels, at least when they are operated through a lease: the activity carried out in a leased hotel is not the offering of hospitality services, but simply the letting of the building to a hotel operator.

The real key to the asset versus going concern issue is whether the property is being sold with or without an asset management structure. It could be argued that if there is no transfer of employees there is no transfer of management structure but, in practice, the asset management is often outsourced to a third party manager. In this context, the subsistence of any asset management agreement becomes a threat to the tax structure of the transaction: if the asset management agreement is transferred together with the asset, the sale is viewed by the Spanish tax authorities as the transfer of a going concern.

The obvious solution, then, is to terminate the management agreement at the time of the transfer of the asset. However, depending on the terms of the existing agreement, this is not always possible. Where such an agreement cannot be terminated, the seller should give notice to the asset manager on the date of the transfer and state very clearly in the purchase agreement that, while the asset management agreement remains in force after the transfer, it does so on a temporary basis only and it is the purchaser's intention to manage the asset through a different service provider.

Even when it is possible to terminate the asset management agreement on the date of the transfer, this is not always practical, as a transition period may be required during which the old and new asset managers co-exist in order to transfer management functions effectively. In these circumstances, the best solution may be to sign a fresh agreement with the new asset manager, terminate the old agreement with the previous manager and replace it with a temporary services agreement during the transition period.

Since every case is different, the management situation of a particular asset must be considered very carefully, and a plan established for succession before the purchase of any property. Otherwise there is a real risk that such an asset sale may be considered to be the purchase of a going concern, with the tax burden that such a classification implies.

CONTROVERSY WHEN ART BECOMES A REAL ESTATE ASSET CLASS

NICHOLAS REDMAN, LONDON

Art has long been used to enliven the civic realm and to stimulate and intrigue residents and visitors. But the installation of art in urban spaces can pose difficult legal issues. This summer saw two local authorities in London tussling over Henry Moore's *Draped Seated Woman* (commonly known as *Old Flo*) as one of them looked at raising £20 million by selling the sculpture. Now, an attempt to regenerate Folkestone on the South East coast of England by the promotion of creativity and the arts has ended up in the High Court.

Art Buff comes ... and goes

The independent arts charity, Creative Foundation, initiated and manages the Folkestone Triennial, an arts project dedicated to exhibiting newly commissioned artworks in Folkestone. As part of the 2014 event, the external flank wall of an amusement arcade in the town was spray-painted with the mural, *Art Buff*. The work was attributed to the famous street artist known only as Banksy. Neither the owner of the arcade nor its tenant, Dreamland, consented to *Art Buff* being painted on the wall. There was huge media interest in the piece, which experts estimate to be worth over £300,000. Local graffiti artists also added their contributions to *Art Buff* before the local authority stepped in and covered the mural with Perspex.

Later, Dreamland severed and removed *Art Buff* from the wall of its arcade. The story moved on quickly: the mural was shipped to New York for sale and exhibited in Miami; the widow of the owner of Dreamland contended that the net proceeds from the sale of *Art Buff* would be given to a local organization providing care to the terminally ill; and the UK Culture Minister demanded that *Art Buff* should be returned to Folkestone.

Art Buff to come back ...

The Foundation took an assignment of the landlord's rights to *Art Buff* as a first step towards its goal of having the work returned to Folkestone and displayed there again. *Art Buff* is presently in New York for safe-keeping pending the resolution of all legal issues. But now the Foundation has obtained a High Court judgment against Dreamland for the return of *Art Buff*.

Dreamland's lease was fairly standard. It obliged the tenant to repair the arcade and to paint the exterior parts, making good all external rendering where necessary, every four years. The judge felt that the presence of *Art Buff* on the

> "The arrival of *Art Buff* on the arcade's flank wall would lead to one party being enriched purely by good fortune—but here that party should be the landlord."

arcade's wall could put the arcade out of repair: there is appeal court authority, *Post Office v Aquarius Properties Limited* [1987] 1 All ER 1055, CA, which makes it clear that an obligation on a tenant in a lease to repair the leased property only operates once the leased property is out of repair. A tenant may decide how it wishes to perform its repairing obligations but it would need to show that the use of a significantly invasive method was as objectively reasonable as other appropriate methods. Against this background, Dreamland failed to show that it was either obliged or entitled to remove *Art Buff* from the arcade in order to comply with its repairing obligations under its lease.

Dreamland also contended that, once *Art Buff* had been removed from the arcade in compliance with its repairing obligations under its lease, it became its property by virtue of an implied term in the lease. Such term would address the issue of what happens to parts of the arcade which Dreamland had to replace or remove in order to comply with those obligations. The parties agreed that such parts, once removed, were personal property, not real property. In most cases (though not this one), such personal property would have little or no value. The judge ruled that a term stating that any such personal property of substantial value belonged to the landlord should be implied into Dreamland's lease on the basis that:

- the landlord owned the property but Dreamland only had a tenancy of it;
- the fact that Dreamland had, it contended, removed *Art Buff* from the arcade whilst performing its repairing obligations in the lease did not confer ownership of *Art Buff*; and
- the arrival of *Art Buff* on the arcade's flank wall would lead to one party being enriched purely by good fortune—but here that party should be the landlord (the judge relied on a nineteenth century case in which a tenant building a gas works uncovered a valuable 2,000-year-old wooden boat under the surface of the land—the boat was ruled to be the landlord's property).

Probably …

The decision was a summary judgment and did not follow a full trial of the issues. The Foundation showed that Dreamland had no realistic prospect of success at trial which is all it needed to do. However, it is possible that Dreamland may appeal on a point of law.

NON-CONVENTIONAL REAL ESTATE ASSETS CAN QUALIFY FOR THE REIT TREATMENT

BENJAMIN BRIGGS AND JESSE CRIZ, CHICAGO AND
BRUCE WEIN AND WITEK JUREWICZ, NEW YORK

Introduction

The US Internal Revenue Service (IRS) recently released a private letter ruling regarding the treatment of certain assets as qualifying "real estate" for real estate investment trust (REIT) purposes. That ruling effectively enabled the taxpayer to convert from a corporation to a REIT.

The taxpayer is a records storage company that provides storage for paper, media records and other items in large warehouse storage facilities. The taxpayer leases and owns space by acquiring leasehold interests and often acquires customers by acquiring the assets of other storage companies or by absorbing the costs incurred by the customer to terminate existing arrangements with other storage companies.

This article provides a summary of the key points addressed in this letter ruling.

Racking: permanent attributes

The taxpayer has extensive steel racking and shelving systems at its warehouses. The IRS ruled that the racking was real property for REIT testing purposes because of the racking's permanent attributes. Among the attributes cited by the IRS were the following: the racking requires a building permit and certificate of occupancy; is made from cold-rolled

> "Lease contract intangibles are inextricably tied to the below-market leasehold interests and are therefore 'real estate assets' for REIT testing purposes."

steel or heavy-duty structural steel; is custom-designed by an engineer or architect; is anchored to the floor; and its design is such that it is likely to outlast the useful life of the building in which it is installed.

Proper treatment of intangibles

Another key issue in the letter ruling was the proper treatment of two types of intangibles possessed by the taxpayer. The taxpayer has "lease contract intangibles," which are the GAAP intangibles attributable to the premium paid by the taxpayer to acquire a lessee's below-market rent leaseholds. The IRS ruled that because the lease contract intangibles cannot exist without the underlying leaseholds, they are inextricably and compulsorily tied to the below-market leasehold interests and are therefore "interests in real property" and "real estate assets" for REIT testing purposes.

The taxpayer also has "storage contract intangibles," which are the GAAP intangibles created when the taxpayer acquired other record storage companies or record storage agreements, and which are attributable to (i) termination fees paid by the taxpayer; (ii) pick-up and move costs and costs incurred by the taxpayer related to the acquisition of large volume accounts; and (iii) costs allocated to the acquisition of storage agreements. The IRS ruled that because the storage contract intangibles are associated only with the storage rental element of the storage contracts, are inseparable from and inextricably and compulsorily tied to the storage contracts, and have no value separate and apart from the storage rental element of the storage contracts, the storage contract intangibles are "interests in real property" and "real estate assets" for REIT testing purposes.

Change in depreciation

The taxpayer had previously been depreciating the racking as "personal property" and amortizing the contract intangibles using a 15-year straight line method. In order to bring its depreciation methodology in line with its view of these assets for REIT purposes, the taxpayer filed an election to change its method of depreciation of these assets to the longer period proper for "real property" and "interests in real property." The IRS, while not ruling directly on the issue, clearly accepted this change of depreciation methodology.

Income from CFCs, PFICs and QEFs

In addition to its US operations, the taxpayer conducts substantially the same operations outside the US through foreign subsidiaries that are either controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs). An issue addressed by the ruling was whether or not certain income attributable to the taxpayer's CFCs and PFICs was considered gross income that helped the taxpayer satisfy the "good income" tests applicable to REITs ("good income"). The taxpayer had elected to treat some of these PFICs as qualified electing funds (QEFs). The IRS analysis and rulings with respect to the taxpayer's PFICs applied similarly to the taxpayer's QEFs. The ruling notes that the legislative history underlying the tax treatment of REITs indicates that a central concern behind the good income tests is that a REIT's gross income should largely be comprised of passive income.

Foreign personal holding company income and PFIC inclusions: Congressional policy objectives

With respect to the taxpayer's CFCs, the IRS ruled that the taxpayer's gross income attributable to the CFCs' "foreign personal holding company income" (which is generally comprised of dividends, interest, royalties, rents and annuities) is "generally passive income" and therefore such income could be treated as good income without interfering with or impeding Congressional policy objectives. Similarly, the IRS ruled that, because PFICs earn income that is "foreign personal holding company income" and such income "generally is passive income," the taxpayer's gross income attributable to its PFICs could also be treated as good income without interfering with or impeding Congressional policy objectives. The IRS therefore ruled that the taxpayer's gross income attributable to its CFCs' foreign personal holding company income and the PFICs will be considered good income.

Section 956 inclusions

The taxpayer also expects to pledge the stock or assets of one or more of its CFCs (a "pledge"), giving rise to an income inclusion to the taxpayer. The taxpayer represented that the REIT used the debt to acquire, improve or develop interests in real property that produce good income, which the IRS viewed as having a close nexus to the REIT's business of owning and renting in real property. The IRS ruled that income inclusions attributable to a pledge will be considered good income to the extent that the pledge secures a taxpayer debt that is used to finance the acquisition of real estate assets that give rise to good income.

Conclusion

This IRS ruling is significant because it represents an increased willingness on the part of the IRS to treat non-conventional assets related to real estate as qualifying real estate assets for REIT purposes.

PARTNERSHIPS BETWEEN THE PUBLIC AND PRIVATE SECTORS IN DUBAI

TREVOR BUTCHER, DUBAI

Background

Dubai Law No. 22 of 2015 Regulating Partnerships between the Public and Private Sectors (PPPs) in the Emirate of Dubai was published in the Official Gazette on 20 September 2015 and will become law on 19 November 2015. This much anticipated new Law will make the implementation of PPPs in Dubai a much more realistic prospect.

PPPs have long been discussed in the Middle East and North Africa (MENA) region but there have been very few examples of successful projects outside of the traditional power and water sectors that generally have their own sector specific legislation. In some countries such as Egypt this lack of progress has been due to wider geopolitical reasons but in others it has been due in large part to the lack of financial need: high hydrocarbon revenues have enabled governments to fund their infrastructure projects from their current budget. Now, however, with low oil prices looking like they will be around for some time to come, interest in PPPs is growing across the region.

The drivers behind the development of PPPs in Dubai are of course unique, but the Government has long been interested in securing private investment in support of its developing infrastructure. Many partnerships and management contracts have been implemented and the Dubai Roads and Transport Authority (RTA) has used a contractor funding model on projects such as Phase 1 of the new Dubai Water Canal. However, there have been no major PPP schemes along the lines of those implemented in other markets around the world and the key question now is whether the new PPP Law will act as a catalyst to generate a pipeline of PPP opportunities in Dubai.

Scope

The Dubai PPP model could potentially be applied to a wide range of different asset classes. The RTA has already announced one major transit-oriented development (TOD) that they intend to procure as a PPP: the Union Oasis scheme is a landmark mixed-use TOD to be developed around the Union Square Metro station. Further TODs are anticipated as part of the Metro extension plans related to Expo 2020 and a number of pure transport schemes are also under consideration.

PPP schemes can also be anticipated in the health sector with Dubai Health Authority having been actively engaged in the consultations on the PPP Law. DLA Piper is already working with one government agency on the development of standard PPP contracts.

The PPP Law is drafted so as to apply both to user-pay (concession-type) projects or availability type schemes where the government entity retains usage risk and pays a service fee.

Projects can have a maximum duration of 30 years unless the Supreme Committee approves a longer period. The default position is that the maximum 30-year term runs from signature of the PPP contract—so not from construction completion—although Article 27 provides some flexibility on the specification of an alternative start date.

Institutional and procedural requirements

It is anticipated that the implementing regulations will provide further detail on the institutional and procedural requirements that will apply to government entities, but the PPP Law includes a number of specific requirements governing project approval levels with projects that have a cost to the government above AED 500 million (approximately US$ 135 million) needing to be approved by the Supreme Committee.

A PPP contract that includes payment obligations for the government entity cannot be concluded unless the payments have been appropriated in that entity's budget. This appears to mean that in order to avoid a delay in signing, departmental budgets may have to anticipate such payments in advance of the completion of the tender process. However, once this initial hurdle is cleared, the Public Funds Administration Law (No. 35 of 2009) permits multi-year appropriations, so this should not be an impediment to implementing schemes.

Freedom to specify tender and contract terms

One of the biggest hurdles to implementing PPP schemes in Dubai up to this point has been the application of the Procurement Law (No. 6 of 1997). This contains a number of requirements concerning tender conditions, timescales and contract terms that do not sit easily with a PPP procurement process or contract. The PPP Law deals with this by disapplying the Procurement Law other than where the PPP contract contains no "clear provision" on a matter.

Articles 14 to 24 of the PPP Law contain provisions relating to the prequalification, tender and selection processes, and PPP contract terms. These provide the government entity with a high degree of flexibility to specify the tender and contract conditions on a case by case basis. The overriding award criterion is the "most financially and technically advantageous bid", but the government entity has a discretion to specify the detail of this, including the balance between technical and financial criteria, in the tender documents.

Unsolicited proposals

It is worth noting that Articles 12 and 14 of the PPP Law allow private entities to make unsolicited proposals for PPP projects and allow the government entity to contract directly with the entity that makes such a proposal. There is no requirement for such proposals to be put to tender and no regulation of the intellectual property rights issues that will arise in this situation. It will be interesting to see whether the implementing regulations deal with these issues, but it may be envisaged that these Articles will generate significant interest within Dubai.

Corporate issues

The PPP Law makes it clear that in most cases the successful bidder for a project must establish a project company to execute the project. Where a project company is to be established it must be either a sole proprietorship or a local or foreign company licensed to operate in Dubai. The project company will need to be properly licensed by the Department of Economic Development in Dubai.

In practice this will mean that in most cases, the project company will need to be an onshore Dubai entity and that free zone entities will not be suitable. This also means that the 51 per cent local ownership requirements of the UAE Companies Law (No. 2 of 2015) will apply to the project company.

The PPP Law gives the government entity the right to hold shares in the project company through an affiliate of the government entity or by a government-owned company. There are no specified levels of the interest that the government entity might hold.

Our initial view is that if the government entity does choose to become a shareholder in this project company, this would have wide ranging implications, not just for the tender and project documents, but also for the status of the project company under Dubai law and its potential treatment as a "Government Company". These issues will need further detailed consideration if any government entity exercises this option.

Funding issues

The PPP Law does not deal with the funding of PPP projects in any detail. Article 36 provides that the government entity (in co-ordination with the Department of Finance) may allow the project company to enter into arrangements with "banking institutions" to finance its business and activities.

The PPP Law does not specifically address the need for government entity/funder direct agreements. Most government entities in Dubai should already have sufficiently broad powers to contract such that this is not an impediment, but it will need to be reviewed on a case by case basis.

Conclusion

The Dubai PPP Law is an overwhelmingly positive step forward in facilitating PPP projects in the Emirate. The key issue now is how the deal pipeline will develop.

PROPOSED NEW CONSTRUCTION CODE IN POLAND

PAWEL BIALOBOK, WARSAW

In 2012 the Codification Committee of Construction Law announced forthcoming amendments to the Construction Code, the main legislation governing construction in Poland. The first draft proposal of the Construction Code was published in April 2014 and the project is currently at consultation stage with the new legislation expected to come into force at the beginning of 2017. The major part of the Construction Code is aimed at regulating issues concerning the production and certification of building materials.

Current legislation

Presently, issues of construction, design and maintenance of buildings in Poland are governed by the Construction Law Act which was passed on 7 July 1994 (the Construction Law). Since coming into force, the Act has been amended almost 70 times with two significant amendments being made as recently as this year.

In addition, there are several other pieces of legislation dealing with construction issues. For these reasons, the Polish system of construction law has come in for much criticism for its ambiguity, inconsistency and overregulation, all of which lead to confusing and unclear decisions in the courts. It was against this background that the Polish government decided to draft and implement an entirely new piece of legislation in order to amalgamate the various strands of the current law and to make it more effective and investor-friendly.

The Construction Code

The Construction Code introduces several significant amendments to Polish construction law. Most of these amendments aim at simplifying and deregulating the investment process. This article goes on to provide a brief summary of the most important proposals.

The most significant innovation introduced by the Construction Code is known as the "construction consent". This may take form of an administrative decision (leading to a construction permit) or a local authority's implied consent (that is, there has been no local authority objection to the notification of the commencement of construction works). This may seem to be a technical and irrelevant modification since the construction consent is a combination of procedures which already exist in the Polish legal system. In fact, however, this change has some important implications for other areas of construction law. For instance, under the current law, only a construction permit may be transferred to another entity. The relevant provision on transfers in the Construction Code, on the other hand, refers to the construction consent, which means, in practice, that the rights and obligations resulting from the local authority's implied consent to construction will also be transferable.

Another significant proposal which should meet investors' approval is the implementation of a rule stating that only construction works, within the meaning given in the Construction Code, are required to be subject to a construction consent. Other types of works, such as reconstruction or renovation works, are exempted from this requirement unless other legal provisions state otherwise. This amendment is especially important for small investors since they will now be able to carry out minor building works without time-consuming and onerous formalities.

The amendment which seems to be the most controversial concerns the situation where a construction permit is declared invalid by the relevant local authority. In terms of the proposal in the Construction Code, a declaration of invalidity will only be possible a year after the permit for use has been obtained. On the one hand, this amendment should be seen as positive as it strengthens market stability and enhances the rights of investors. However, it may lead to a situation where a building is actually occupied, when its construction has gone ahead based on a construction permit issued despite gross, or less serious, infringements of the law.

It is fair to say that the new construction law appears to be less oppressive than the current law. The amendments which

reflect this lighter approach mainly concern provisions relating to the validation of unpermitted construction and violations of construction law. In relation to the validation of works carried out without the required construction permit, the Construction Code is going to be much more flexible, basing the amount of the validation fee on the value of unpermitted construction that has taken place. In terms of the provisions on violations of construction law, a local authority will not be able to immediately impose administrative penalties. Under the Construction Code, the local authority must first ask the developer to refrain from violating the law, and only if the violation is not removed, will the authority then be entitled to impose administrative penalties. This is a positive change which will put an end to situations where investors are automatically punished for violations of law which are unintentional and which may easily be removed.

There are also minor amendments proposed which aim at simplifying and speeding up the investment process, such as reducing the time taken by the administrative body to examine a notification of the commencement of construction works, and reducing the number of projects which require construction permits or permits for use.

Conclusion

The reactions of investors and commentators to the announcement of the new Construction Code have been mixed. The majority of proposals seem to meet investors' approval in terms of the increased flexibility and greater simplicity of the investment process they offer. Nevertheless, there have also been some criticisms of the project by those who view the proposals as giving investors too much freedom in the construction process, leading to the potential for architectural chaos. It should be remembered that the drafting of the new Construction Code is still in its early stages and numerous modifications to the current proposals should be expected in the future.

THE PRINCIPLE OF GOOD FAITH IN LEASE NEGOTIATIONS

MARYANA KABAKOVA, MOSCOW

Introduction

The Civil Code of the Russian Federation was recently amended to incorporate revised provisions (the Amendments) relating to the principle of good faith in lease negotiations. This article looks at the implications of the Amendments and assesses what changes, if any, need to be made to the way those in business negotiate in order to comply with the legislation.

The principle of good faith was already one of the main tenets of Russian civil law before the Amendments were made. However, no specific criteria were laid down as to what constitutes acting in good or bad faith in the course of lease negotiations.

Acting in bad faith in the course of negotiations

Under the Amendments, the following criteria are indicative of bad faith in the course of negotiations:

- Entering into lease negotiations with no intention of reaching a binding agreement, for example, conducting negotiations merely to prevent an agreement being entered into with a competitor or as a means of obtaining important commercial or other information. Conducting negotiations simultaneously with several tenants or landlords may or may not be considered as acting in bad faith, depending on the circumstances. For example, where negotiating with a competitor of one of the parties is not permitted, simultaneous negotiations with that competitor may be considered as constituting bad faith.
- Providing the other party with incomplete or inaccurate information, including failing to disclose circumstances which should have been brought to the other party's attention, due to the nature of the agreement. This may include, for example, information on (i) the financial position of the tenant or landlord; or (ii) specific characteristics of the leased property, including its occupancy rate at the time when negotiations are taking place, the expected timeframes for completing construction of a building or circumstances which may delay such completion.
- Unexpectedly or unreasonably terminating negotiations in circumstances where the other party could not reasonably expect negotiations to be terminated.

The Civil Code does not provide an exhaustive list of actions which may be considered to constitute bad faith. According to the most recent case law from the Supreme Court of the Russian Federation, parties in lease negotiations will be judged according to an objective test of reasonable behaviour. Specifically, each party must consider the rights and legitimate interests of the other party and assist the other party, among other things, in obtaining the necessary information. It should also be noted that a party to negotiations may be considered to be acting in bad faith not only where the other party raises a complaint, but also at the instance of the court itself if the party has clearly deviated from the principles of good faith.

In order for the court to intervene, the following actions may be considered to constitute bad faith:

- Deliberately delaying the negotiation process, including failing to come to meetings or respond to the other party's requests or correspondence, etc;
- Proposing and insisting on provisions which are clearly unacceptable for the other party or which do not correspond to general market practice (for example, early termination of the agreement at any

> If in the course of negotiations the party was provided with incomplete or inaccurate information the resulting agreement can be considered invalid.

time without cause and subject to no penalty, or an unreasonably high security deposit);
- Unreasonably refusing all conditions or proposals, etc of the other party.

Documents which may indicate good faith in the course of negotiations

In order to protect their interests in the course of conducting negotiations, the parties may draft the following documents to support their claims that they acted in good faith in case of a dispute:

- For institutional landlords—the development of standards or policies establishing clear rules for their employees and third parties (for example, real estate brokers or other agents) on conducting negotiations with potential tenants;
- Minutes of meetings which may serve as additional proof of the relative bargaining positions of the parties, reciprocal concessions made in the course of negotiations, etc.

Agreement on conducting negotiations

Under the Amendments, the parties can now enter into an agreement specifying how negotiations are to be conducted (the Agreement).

The Amendments do not lay down specific requirements for the content or form of the Agreement and only provide that it may specify precisely the requirements for acting in good faith in the course of negotiations, determine the procedure for allocating the expenses of negotiations between the parties, and establish other rights and obligations. In the absence of specific requirements for the form such an Agreement may take, it is suggested that this may be a separate, signed document or may form an obligatory provision of the parties' letter of intent (separate from other provisions of the letter of intent which usually describe the non-binding pre-contractual arrangements of the parties with respect to the main terms and conditions of the transaction).

The Amendments expressly provide that the Agreement may specify a penalty for breach of its provisions and that any provisions in the Agreement on the limitation of liability for acting in bad faith are void.

Liability for acting in bad faith

The Amendments provide that a party who conducts or terminates negotiations in bad faith must reimburse the other party for any expenses incurred in connection with:

- the conduct of the negotiations (for example, real estate brokers' fees and legal fees, etc);
- the loss of the opportunity to enter into an agreement with a third party.

It is submitted that a third party can be an alternative party for the transaction (such as another landlord or tenant) or a party with which negotiations were held with respect to the conclusion of another (ancillary) agreement for the transaction (for example, for the performance of fit-out work or the supply of equipment).

Other possible consequences of the Amendments

The criteria constituting bad faith introduced by the Amendments may now also be considered by courts in the following disputes which were traditionally difficult to prove in practice:

- A challenge to an agreement entered into under the influence of a mistake or fraud. For example, if in the course of negotiations the party was provided with incomplete or inaccurate information or if certain circumstances which may be deemed important based on the nature of the transaction were not disclosed, then the resulting agreement can be considered invalid;
- An abuse of a right. For example, if negotiations were held just to prevent an agreement being entered into with a competitor or for the purpose of obtaining some important commercial or other information, then such actions can be considered as an abuse of a right and result in liability for the party who acted in bad faith. In this case the other party can claim compensation in full for losses suffered.

Conclusion

The Amendments establish good faith criteria and require those involved in the negotiation process to act more cautiously in order to avoid possible claims that they acted in bad faith during the course of negotiations. In addition the Amendments also allow a party to protect its interests in cases where the other party has acted in bad faith. However, it remains to be seen how these criteria will be interpreted and applied by the courts.

COMMERCIAL LEASES IN SWEDEN—ALTERNATIVES TO CUSTOMARY INDEX ADJUSTMENT CLAUSES

JAN RÅSSJÖ, DLA NORDIC, STOCKHOLM

The main principle in Chapter 12 of the Swedish Real Property Act is that the rent for commercial premises should be a fixed amount, known as the base rent. This main principle notwithstanding, the landlord is entitled to charge the tenant, in addition to the base rent, supplements for heating, hot water, electricity and sewerage services. The rent can also be calculated based on the turnover of the tenant's business in the premises.

Where the lease is for a fixed period of at least three years, additional principles apply. In particular, the landlord can include clauses in the lease which provide for the reimbursement of real property tax, for costs that were not known at the date of entering into the agreement and other adjustments to the rent.

The most common rent adjustment clause is one that allows the rent to be calculated in line with the annual changes in the Consumer Price Index (CPI). The starting CPI figure is usually either the CPI figure for October in the same year as the initial lease term starts if the starting date of the lease is between 1 July and 31 December, or the CPI figure for October in the previous year, where the lease term starts between 1 January and 30 June. Some recent index adjustment clauses have also stipulated a quarterly rent adjustment, but these are too rare as yet to be considered common market practice.

The index adjustment clause usually limits the adjustment so that the rent will never be lower than that set out in the lease. A common alternative wording of the index adjustment clause is that the rent may never be lower than last year's rent, which effectively prevents the rent from being decreased over the term of the lease. However, the rent may remain static for several years should there be no change in the CPI. Legislation governing relations between landlords and tenants in Sweden is drafted in terms that protect tenants' rights, so it is crucial that the index adjustment clause is correct and clear in its wording. Otherwise the clause may be declared void.

For the last couple of years, the CPI and inflation in Sweden have been more or less static or have even been negative. This has led landlords to look for alternatives to the customary index adjustment clause. It will be recalled that, in the case of fixed term leases of at least three years' duration, the legislation allows for methods of calculation of the rent other than that provided in Chapter 12, and it is possible to link the rent adjustment to other indices besides the CPI. However, it is recommended that the index used should be well recognized and historically stable in order to avoid uncertainty in its application or interpretation.

It is also possible to agree on a fixed increase in the rent, either on a yearly or quarterly basis. There has been a notable increase in the use of this method, with the increase provided in this type of clause customarily being set at 2 to 3 per cent per year. A combination of the two methods, namely linking the adjustment clause to the CPI (or another index) and supplementing this with a minimum increase of, for example, 2 per cent, is also commonly used. The wording and application of the clause must be precise, otherwise there is a real risk that the clause will be deemed invalid. This risk is borne by the landlord, since it is customarily the landlord who drafts the lease.

It should also be noted that where a commercial lease is for a term longer than nine months, this is automatically extended after the initial lease term if neither the landlord nor the tenant gives notice of termination. The right to insert rent adjustment clauses or other alternative methods of calculating the rent is connected to the length of the present lease term, not the actual time the tenant has leased the premises. Therefore, it is important to ensure that the extended term is for at least three years. If not, the landlord's right to adjust the rent in line with various index clauses (and also, for example, to claim back any payment of real property tax) will be lost after the initial lease term.

To conclude, landlords should consider the various options available in relation to rent adjustment clauses carefully and ensure that all such clauses are framed precisely and accurately in order to avoid the risk of these being declared invalid.

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