CADWALADER

Keep Calm and Carry On

March 31, 2023

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Market Disruption

March 31, 2023

The last few weeks have again been disruptive and momentous (I am loath to say unprecedented as, unfortunately, we have been here before). SVB, Signature, First Republic and Credit Suisse are the names of the moment. Will there be others? We shall see.

Cadwalader has been tracking these developments and has provided timely thought pieces on these matters in real time. Please visit our **Financial Markets Resource Center** for the most up-to-the-minute developments and analysis. We will continue to update this space as needed.

In addition, please feel free to reach out to your contacts to answer any specific inquiries. Maybe the markets need to remember a well-known phrase: Keep calm and carry on.

UK Budget 2023 – Key Tax Measures Impacting Real Estate

March 31, 2023

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The Chancellor of the Exchequer delivered the United Kingdom ("UK") Budget for 2023 on 15 March 2023.

The Budget was delivered against a backdrop of some familiar political headwinds, caused by the lengthy shockwaves of the COVID-19 pandemic, the war in Ukraine and high interest rates. The stated intention of the Chancellor was to restore economic stability, support UK public services, and lay the foundation for long-term growth. The tax developments announced in the Budget reinforce these objectives. Some of the technical taxation proposals in the Budget were published in draft legislative form by the UK Government in July 2022 but bear the signs of extensive consultation and development since their original announcement.

In this article we have outlined the key tax measures that we expect to be of interest to Cadwalader's real estate clients. A more detailed analysis can be found in our **Clients & Friends Alert**.

Qualifying Asset Holding Companies

Since its introduction in April 2022, the UK's qualifying asset holding company ("QAHC") has been successful in terms of take-up and investor interest. The purpose of the regime is to deliver a proportionate and internationally competitive tax regime for asset holding companies which are resident in the UK, by means of a simplified set of tax rules applicable to QAHCs that are intended to tax investors as if they had invested directly in the QAHC's underlying assets.

One of the focus points of the QAHC regime has been facilitating investment by funds. In this context, the QAHC regime contains certain limitations on how an asset holding company owned by a private fund can qualify as a QAHC. One key condition is that the asset holding company must be owned as to at least 70 per cent. by "category A investors" which (relevantly for a private fund) includes a "qualifying fund." A "qualifying fund" is a collective investment scheme which meets a "genuine diversity of ownership" threshold.

Proposals were made by the UK Government in July 2022 for amendments to the QAHC regime, and those proposals have largely been confirmed in the Budget. Some additional provisions have also been announced.

The changes to the QAHC regime include the following provisions:

- The QAHC legislation shall be amended to confirm that a company which is within the tax-favoured regime for UK "securitisation companies" cannot also, simultaneously, be a QAHC. There has been some discussion of this point in the taxation press and HMRC consultation groups, but the statement by the UK Government in the Budget press releases, and any proposed legislative changes, will put the point beyond doubt.
- An amendment will be included in the QAHC legislation to allow an investment fund to be treated as meeting the genuine diversity of ownership threshold when that investment fund is closely associated with another investment fund that satisfies that threshold. The policy rationale is to facilitate investment by multi-vehicle, associated and parallel investment funds whose management is substantially coordinated such that they act together in relation to their investments as if they were a single fund.
- Changes will be made to the QAHC regime to facilitate participation in a QAHC by certain fund entities. When the QAHC regime was introduced, the definition of a "qualifying fund" required a fund vehicle to be a collective investment scheme ("CIS"), following the definition which is used for UK tax purposes. Certain non-UK entities that

would be a CIS from a general perspective might not fall within the precise UK tax definition if they were established as a body corporate under their local law. The UK Government has announced that amendments will be made to the QAHC legislation to ensure that fund vehicles which would be a CIS if they were not a body corporate shall be treated as if they were a CIS; such fund entities can therefore satisfy the requirement of being "qualifying funds," subject to other conditions being met.

- The existing anti-fragmentation rule in the QAHC legislation will be extended to exclude from the regime structures involving more than one QAHC in which the combined percentage of relevant interests that are not held by eligible "category A investors" exceed 30 per cent.
- Amendments will also be made to allow an election which treats listed securities as unlisted. The eligibility criteria for entrance into the QAHC regime includes an ownership, activity, and investment strategy condition, requiring that the QAHC does not have a strategy of investing in listed equities or interests which derive their value from listed equity positions. The proposed change will allow a QAHC to hold listed securities and still meet the investment strategy condition, but the QAHC will be taxable on the dividend income receivable from such securities. Various protections will be included to prevent companies entering into arrangements to avoid the dividend income being taxable.

Most of the changes will have effect on and after the date of Royal Assent of Finance (No 2) Bill 2023 ("Finance Bill"). However, (i) the clarification that a securitisation company cannot also be a QAHC has effect from 15 March 2023 (the date of the Budget); (ii) the extension of the anti-fragmentation rule has effect from 20 July 2022 (when draft provisions were published); and (iii) the amendment to the definition of a collective investment scheme, and certain other changes, have effect from 1 April 2022 (the commencement of the QAHC regime).

UK Real Estate Investment Trusts ("REITs")

As part of a speech announcing the Edinburgh Reforms in December 2022, the UK Chancellor of the Exchequer announced that changes would be made to the UK REIT regime in the Finance Bill. These changes are motivated by the UK Government's intention to further increase the attractiveness of the REIT regime.

The changes will remove the requirement for a REIT to own at least three properties in its property rental business if the REIT holds a single commercial property worth at least £20 million.

The UK Government will also amend the rule that deems a disposal of property within three years of being significantly developed as being outside the property rental business of the UK REIT, so that the valuation used when calculating what constitutes a significant development better reflects increases in property values and is not distorted by inflation.

Changes will also be made to amend the rules for deduction of tax from property income distributions paid to partnerships to allow a property income distribution to be paid partly gross and partly with tax withheld. The distribution will be permitted to be paid gross to the extent that it is the income of partners that would be entitled to gross payment if they held an interest in the REIT directly.

These changes were welcomed by the UK property investment sector when announced in December 2022, and broaden the scope and flexibility of the UK REIT sector. The changes announced to the disposal of property will be introduced on 1 April 2023. The UK Government appears to intend that the other changes mentioned above related to REITs will be made with effect from Royal Asset to the Finance Bill (although there is a slight conflict in the Budget documentation in respect of confirming that date as being the relevant one, as opposed to 1 April 2023).

Amendments to the Genuine Diversity of Ownership ("GDO") Condition

The GDO condition is used as a condition in the QAHC, UK REIT and Non-Resident Capital Gains ("NRCG") rules. Under current law, the GDO condition must be applied to each entity within a fund structure in isolation. Therefore, a particular entity can fail to satisfy the GDO condition, even though it forms part of a wider arrangement which, when taken as a whole, would meet the relevant requirements.

As noted above in the context of QAHCs, to address this problem, an amendment will be made to the GDO condition for the purposes of the QAHC regime, and comparable changes will be made to the REIT and NRCG rules. The legislative amendments will ensure that where an entity forms part of "multi-vehicle arrangements," the GDO condition can be treated as satisfied by the entity if the GDO condition is met in relation to "multi-vehicle arrangements."

The definition of "multi-vehicle arrangements" encompasses a group of entities which form part of a wider fund structure where an investor would reasonably regard their investment to be in the structure as a whole.

This measure will have effect on and after the date of Royal Asset to the Finance Bill.

Carried Interest – Elective Accruals Basis

Whilst the taxation of carried interest is often mooted as a possible target of Budget announcements, the Budget has proposed only a minor (albeit meaningful) change. The UK Government has announced that changes will be made to ensure that effective double taxation relief can be claimed by UK tax resident individuals in receipt of carried interest.

At present, carried interest that is taxable under the capital gains tax regime is taxable when the carried interest arises to the individual. This position is not necessarily consistent with the taxation of carried interest in other jurisdictions and thus relief under a double taxation treaty may be precluded owing to timing differences in the recognition of such amounts. This has recently been a friction point between the respective UK and United States timing of the taxation of carried interest.

As such, the changes will permit an individual who expects to receive carried interest to make a voluntary but irrevocable election for that carried interest to be taxed on an accruals basis. This is intended to remedy the situation in which individuals cannot claim double taxation relief from other countries, owing to such amounts being taxed at different times in two jurisdictions.

This measure will take effect from the date on which the Finance Bill receives Royal Assent.

UK Budget 2023 – Sovereign Wealth Funds Not Subject to Corporation Tax

March 31, 2023

By **Duncan Hubbard**
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By **Adam Blakemore**
Partner | Tax

By **Carl Hey**
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As part of the Spring 2023 Budget, Chancellor Jeremy Hunt has scrapped plans to require sovereign wealth funds to pay corporation tax on property and commercial enterprises.

The United Kingdom ("UK") government had launched a consultation on 4 July 2022 to "modernise and improve the tax treatment it provides to foreign sovereign investors, such as heads of state and sovereign wealth funds." In connection with the consultation process, Treasury had planned to introduce **these changes** in April 2024.

However, the position was reversed at **paragraph 4.64 of the Budget**:

"The government has carefully considered the responses to the consultation on sovereign immunity from direct taxation. It has decided that there will be no change to the current exemption, and that it will continue to operate as it does now. The government welcomes the constructive engagement with sovereign investors during the consultation, and over the longer term."

The effect of the Budget announcement is that the current position will remain, so that taxpayers benefiting from sovereign immunity will continue to be exempt from UK direct taxes (*i.e.*, income tax, capital gains tax and corporation tax on all UK-source income and gains). Further, eligible taxpayers will continue to be treated for the purposes of the real estate investment trust ("REIT") and qualifying asset holding company ("QAHC") regimes as "Qualifying Investors," and as "Qualifying Institutional Investors" for the purposes of the substantial shareholding exemption from corporation tax on chargeable gains.

Very broadly, our initial response to the Budget announcement is that it is helpful that the Government has taken on board comments and worked with "stakeholders" before making any changes or, as here, not proceeding with the proposed changes to the current exemption. The current rules for sovereign immunity are relatively generous, and therefore it might be considered that the current rules are aligned from a tax policy perspective with the Chancellor's approach of encouraging investment into the UK (*i.e.*, via REITs and QAHCs).

Please feel free to get in touch with the Cadwalader team to discuss the contents of this update.

Basel 3.1 – Implications for the Real Estate Finance Market

March 31, 2023

By **Alix Prentice**
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Partner | Real Estate

On 30 September 2022, the Prudential Regulation Authority (the "PRA") published Consultation Paper 16/22 (the "Consultation Paper") proposing for the **implementation of Basel 3.1 standards in the UK**. The consultation closes on 31 March 2023, with the proposed implementation date beginning 1 January 2025 (with a transition period of five years from that date for most provisions).

This article sets out a summary of the key changes of interest to those in the real estate finance ("REF") market.

Background

The Basel 3.1 standards were published by the Basel Committee on Banking Supervision ("BCBS") on 7 December 2017, with an original implementation date of 1 January 2022 delayed due to COVID-19.

The Basel 3.1 standards are the parts of the Basel III standards that remain to be implemented in the UK. The Basel III standards that have been implemented in the UK have primarily focused on increasing the quantity and quality of capital maintained by firms (*i.e.*, the numerator of capital ratios) and also introduced new requirements for leverage and liquidity.

Concerned that downward movement in average risk weights (measured by the ratio of risk-weighted assets ("RWAs") to assets) over the last 10 years is due to fairly pervasive underestimation in internally-modelled risk, the PRA is proposing to align with international standards and implement the final Basel III package of significant changes to the way firms calculate RWAs. The PRA's aim is to mitigate the threats to confidence caused by degrees of variability in calculation of risk weights and resultant inconsistencies in capital ratios and difficulties in comparing like-for-like.

The proposals in the Consultation Paper address mainly the final element of the Basel III standards – the measurement of RWAs (*i.e.*, the denominator of capital ratios). The proposals would, among other things, revise the calculation of RWAs by improving both the measurement of risk in internal models ("IMs") and standardised approaches ("SAs"), and the comparability of risk measurements across firms.

Summary of Key Changes

General

Basel 3.1 standards include revised standard and internal ratings-based approaches for credit risk, revisions to the use of credit risk mitigation techniques, a revised approach to market risk, the removal of the use of internal models for operational risk capital requirements and for credit valuation adjustment and their replacement with new standard and basic approaches, and the introduction of an aggregate "output floor" to ensure that total RWAs using internal models cannot fall below 72.5% of RWAs derived under standard approaches.

This means a more granular set of standard approaches for assessing risk exposures and the removal of some internal model approaches, as well a new modelling approach for internal ratings-based assessments, alongside improvements to the trading book/non-trading book boundary.

Real Estate Loans under Credit Risk Standardised Approach

The Consultation Paper proposes changes in respect of the treatment of real estate loans (either secured on commercial property or on residential property). The overall intended effect of these changes would be to bring SA RWAs for real estate lending closer to those under the internal ratings-based approach ("IRB"), particularly for low-risk residential mortgages, while introducing new requirements to help ensure RWAs for real estate exposures are appropriate.

In summary, real estate loans would be divided into two categories, namely:

1. "regulatory real estate exposure" which meet six specific conditions that are consistent with the relevant Basel criteria (namely: (i) it is finished; (ii) there is legal certainty on claims over the property; (iii) the exposure is secured by a first charge over the property; (iv) an assessment is made on the ability of the borrower to repay; (v) it is prudently valued; and (vi) adequate documentation is maintained); and
2. "other real estate" in cases where these requirements are not met.

Each of these categories would in turn include different sub-categories distinguishing between loans secured on residential real estate and loans secured on commercial real estate.

For regulatory real estate loans, a loan-splitting approach would apply whereby real estate loans with a loan-to-value ("LTV") ratio below a certain level receive a lower risk weight with any excess above that level being subject to a higher risk weight. This means that for these loans, the prudent valuation of the collateral securing the loan would become increasingly important given the proposed key role of LTV to calculate the applicable SA risk weight.

For other real estate loans, the proposed approach is closer to the current one – but with revisions.

Conclusion

Our regulatory specialists are currently working with the Commercial Real Estate Finance Council ("CREFC") Europe on industry feedback to the Consultation Paper.

Please feel free to get in touch with the Cadwalader team to discuss the contents of this update. We will provide further updates on this topic in due course.

*This article was also published in Cadwalader's "**Cabinet News and Views**" newsletter.*

It’s Time for a New Damages Calculation: SDNY Bankruptcy Court Applies the Time Approach to Limit Damages in Lease Terminations

March 31, 2023

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Associate | Real Estate

Since 1993, decisions out of the U.S. Bankruptcy Court for the Southern District of New York consistently adopted the aggregate “rent approach” for calculating lease rejection damages in bankruptcy proceedings. But in Bankruptcy Judge Wiles’ recent decision in *In re Cortlandt Liquidating LLC*, he departed from the “rent approach” in favor of the “time approach,” which is based on the time remaining under the lease rather than factoring in the total or aggregate rent still owed under the lease. The *Cortlandt* decision is aligned with the trend in the case law and may indicate how lease rejection damage claims will be calculated in Southern District of New York bankruptcy proceedings moving forward.

By way of background, in order to limit the dilution of the general unsecured creditor claim pool by large damage claims resulting from a debtor-tenant’s rejection of an unexpired lease, Congress capped the damages recoverable for lease rejections in bankruptcy cases. The current formulation of that cap is codified in Bankruptcy Code section 502(b)(6): “the rent reserved by such lease, without acceleration, *for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease*, following the earlier of − (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property. . . .” (Emphasis added.)

The “one year” component is readily determined − the rent for the year following the petition date or surrender or repossession of the leasehold. Landlords and tenants dispute the calculation of the “15 percent” component. The rent approach to calculating lease rejection damages, preferred by landlords, imposes a cap on damages determined by a percentage of the rent owed for the entire remainder of the lease term − such percentage is equal to 15 percent of the total dollar amount of rent still owed, so long as that dollar amount is at least equal to the rent reserved for one year and does not exceed the rent reserved for the next three years. The rent approach captures rent escalation amounts arising later in the lease term.

By contrast, the time approach, favored by debtor-tenants and non-landlord general unsecured creditors, calls for a temporal limit equal to the rent reserved under the lease for the next 15 percent of the remaining term, so long as that time period is at least one year and does not exceed three years. The time approach effectively excludes rent escalation amounts arising later in the lease term.

As Judge Wiles notes, the differences between the time approach and the rent approach are irrelevant in cases where it is clear that the section 502(b)(6) cap must be based either on the one-year rent minimum or the three-year rent maximum. However, where the damages fall somewhere in between, the time approach’s calculation will, to the detriment of impacted landlords, not capture periodic rent escalations built into long-term leases.

Despite the Southern District applying the rent approach as recently as 2011, Judge Wiles grounded his decision in the plain meaning of section 502(b)(6). According to Judge Wiles, Congress’ intent to cap damages by reference to time is evident in their use of the words “one year” and “three years” to modify the phrase “of the remaining term of such lease.” Therefore, “15 percent” must be read to further modify the same phrase. Judge Wiles was further persuaded by the fact that other courts and noteworthy bankruptcy treatises have withdrawn support for the rent approach since the SDNY decision in 2011.

Additionally, Judge Wiles was unconvinced by arguments based on principles of equity and fairness, explaining that perceptions of equity and fairness will change depending on perspective − landlords may find the time approach unfair

or inequitable, while other unsecured creditors would likely take the opposite view. In Judge Wiles' view, the fact that there is a cap on lease rejection damages in the first place shows that Congress intended to limit landlords' claims and "Congress plainly sought to strike a balance between the interests of landlords and other creditors, whose claims might be diluted if landlords were allowed to assert very large lease termination claims."

Much to landlords' dismay − especially in a year that brings with it a degree of financial stress − application of the time approach could result in landlords recovering a smaller sum than they would under the rent approach. However, judges presiding over future bankruptcy cases in the Southern District of New York will not be bound by Judge Wiles' adoption of the time approach, and therefore it remains to be seen whether future decisions will follow Judge Wiles' lead or revert to the previously used rent approach.

Landlords may be assuaged somewhat by Judge Wiles' additional determination that certain tenant obligations that arise independent of the termination of the lease, such as repair obligations and mechanic's lien claims, are not subjected to the capped breach damages provision.

The Cadwalader team will continue to monitor future cases in this area and provide updated insights on any such developments as they arise.

Strafford Webinar on ‘Special Purpose Entities in Real Estate Transactions: Structuring and Documentation’

March 31, 2023

Cadwalader real estate partner Steve Herman and financial restructuring partner Kathryn Borgeson will participate in a Strafford-sponsored live video webinar, titled “Special Purpose Entities in Real Estate Transactions: Structuring and Documentation,” on Tuesday, May 2, from 1-2:30 p.m.

This CLE course will prepare real estate counsel to structure special purpose, bankruptcy-remote entities that satisfy commercial mortgage-backed securities and portfolio lenders' requirements. The panel will discuss current separateness provisions, the conditions and documentation for independent directors, single-member LLCs and special member provisions, and the components of an acceptable non-consolidation option. There will be a live Q&A session with participants after the presentations to answer questions directly about these important issues.

Cadwalader has a limited number of complimentary and discounted registrations. For more information, please contact **Paulette Stone**.

Steven Herman and William Lo Named Real Estate Thought Leaders

March 31, 2023

Real Estate Finance partner Steven Herman and associate William Lo were named recipients of JD Supra's "Readers' Choice Awards" for Real Estate. The awards recognize top authors and firms who were read by C-suite executives, in-house counsel, media, and other professionals across the JD Supra platform in 2022.

This is the third straight year that Herman has been recognized for his thought leadership. Previously, he was named by The National Law Review as a Real Estate thought leader. Herman is a frequent writer of Cadwalader Clients & Friends Memos on a broad range of real estate topics and is also co-editor of the firm's monthly ***REF News and Views*** newsletter. Herman concentrates his practice in the areas of real estate finance, development, joint ventures, acquisitions, dispositions, commercial leasing, restructurings, workouts, and commercial mortgage securitizations.

Lo's real estate finance experience spans across a variety of UK, pan-European and global transactions, as well as a diverse range of real estate assets, including hotels, commercial and residential building complexes, and health care and logistics centres.

Recent Transactions

March 31, 2023

Here is a rundown of some of Cadwalader's recent work on behalf of clients.

- Represented the lenders in connection with a $625 million loan secured by 58 select service hotels in 20 states.
- Represented the administrative agent and initial lender in the origination of an approximately $275 million loan secured by a retail property located in California.