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Investing in Real Estate - Legal Risks

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Abstract. In recent years an increasing number of people are going abroad for real estate investment. Some investors are looking for a better return on investment through higher yields as compared to other investment vehicles. Investing in real estate can be a good way to own some land and build long term wealth. High risk comes for example from residential rentals due to the fact that there are many local and national laws that govern how human living spaces can be designed. Laws provide for minimum size requirements, minimum requirements for square footage and the amount of people who can occupy a home, safety requirements and more. Besides, there are many local laws which can restrict how quickly an investment owner can remove a tenant from their rental unit. Evictions of tenants can require posting of eviction notices, waiting periods, court hearings and other issues. With commercial, retail and warehouse real estate investment if the economy is down and the tenant cannot afford to pay rent or they file for bankruptcy the investor may not be able to replace them as easily. But laws with regards to commercial real estate are not as restrictive as they are with residential. If about legal risk, when evaluating markets to invest in, population growth and employment rates are important. Local laws can make a big difference when it comes to success or failure in a given market. It's impossible to eliminate the market risks on future pricing, interest rates and inflation. Nobody can influence and control future market risks. The controllable risks are connected to the property. They are based on infrastructure, competitors, political and legal environment, area-development, tax and legal exposures. Amid the rapid development of overseas real estate investment, the associated legal risks have gained increasing attention.

Keywords: real estate, investment, property, lease, rental

1 Introduction

Economic development, the increase in the wealth of the society and the emergence of new capitals encourage investors to seek new investment areas, including real estate investments (Åslund 2010, 53-55). Investing in real estate is one of the ways of investing in addition to investment opportunities such as acquisition of shares in business entities and investment funds, as well as securities (Kucharska-Stasiak 2006, 40). The property protects capital (Bieniek, Rudnicki 2013, 20-47) against impairment as a result of unfavorable market changes and high inflation, provided that we will consider this process in the long-term perspective (a feature of the property as an investment) (Ribeiro, Ferreira, Jalali, Meidut˙e-Kavaliauskien 2017, 140–156). It is also important that when investing in real estate, we must have significant capital. Economic risk (Adair, A., Hutchison, N.E. 2005, 254–268) is a natural consequence of running a business by entrepreneurs. As late as February 2020, no investor buying or renting flats for short-term rent assumed the scenario that occurred in connection with the coronavirus pandemic. In the long run, the property does not lose its value (Kozioł-Kaczorek 2014, 219-235), which means that it also protects against inflation.

2. Legal risks

The concept of legal risk is broad and covers the process of making, applying and complying with it (Byrne, Lee 2004, 501–511). Legal risk is associated with the possibility of incurring losses that undoubtedly affect the financial result of a given entity, and thus its competitiveness, may be tangible or intangible. Legal risk is one of the distinguished sub-categories of operational risk, which is not legally defined in the EU law system. Certain laconic statements are contained only in par. 644 of the report of the Basel Committee on Banking Supervision[1], indicating that operational risk includes legal risk, but does not include strategic and reputational risk. Legal risk is not a uniform concept, and therefore it seems necessary to distinguish at least several subcategories of this type of risk in order to properly understand its essence. There are several subcategories of legal risks.

The dynamics of legal changes in Poland means that it is often difficult to adapt to all new regulations. Therefore, the risks related to the violation of the law begin to pose a real threat to the company's operations. However, there are ways in which the impact of such risks on the organization can be reduced and the tools that can be used to do so. Legal risk is the possibility of suffering financial and reputational losses as a result of conducting business activity inconsistent with applicable legal provisions and involving difficulties resulting from compliance with and enforcement of the terms and conditions contained in contracts and agreements with other entities. Legal risk management is not always considered a priority at the initial stage of an investment. In practice, the lack of planning of appropriate activities leads to a reduction in the effectiveness of investment implementation. Legal risk management allows you to minimize the impact of negative factors that arise during its performance. It is important to monitor the investment status consistently and properly react to any irregularities and potential threats. Such activities will ensure legal comfort and may significantly contribute to the success of the investment process.

2.1 Risk of loss

The largest subcategory of legal risk is loss risk, which should be understood as the potential possibility of incurring operational losses and loss of assets (Coleman, Mansour 2005, 37-54). An example of events that may generate a risk of loss is incorrect performance of contracts between the parties. However, this does not mean that you should give up your investment, but only define your own level of investment risk tolerance to avoid adverse events.

2.2 The risk of litigation

Another category of legal risk is related to events that result in both the potential possibility of instituting proceedings in all existing procedural modes (civil, criminal, administrative and tax), as well as the probability of issuing unfavorable decisions for a given entity. As an example of events that may generate the risk of litigation, there is a defective performance of obligations imposed on the party, resulting from legal norms, as well as from the provisions of civil law contracts and other legal acts of a private law nature, which results in the basis for third parties to initiate specific proceedings.

2.3 The risk of misinterpretation of legal regulations

A very important subcategory for the analysis (Sdino, Rosasco, Magoni 2018, 1-13) of legal risk is also the risk of misinterpretation, which results from an incorrectly conducted analysis of generally applicable provisions of law. As indicated by the Provincial Administrative Court in one of its judgments, "An incorrect interpretation means incorrect reconstruction of the content of a legal norm resulting from a specific provision, i.e. a misunderstanding of a specific legal norm, while an incorrect application is making a defective subsumption of a provision to the established factual state, i.e. unjustified recognition that the state the facts of the case correspond to the hypothesis of a specific legal norm”.

2.4 Legislative risk

[1] https://www.bis.org/bcbs/index.htm

It is an external risk that is not directly influenced by the persons responsible for operational risk management in a given organization. This risk results from changes in the law, prepared and adopted by the legislator, which are unfavorable for the conducted activity. Changes in the law with regard to all types of entrepreneurs (for example changes in tax law) may worsen the conditions of activity, significantly affecting the profitability (profitability) of the activities conducted by banks. Thus, constant monitoring of legislative work, both in the national and EU dimension, seems necessary.

2.5 Reputation risk

Caring for the company's reputation is of paramount importance. Any spectacular mistakes and legal flaws related to the functioning of a given entity, in particular publicized by the mass media, may significantly affect the loss of customer trust, and also focus particular attention of prudential supervision on the standards of conducted activity. Such events may, in the worst case, lead to losses due to the "departure" of a significant number of clients and contractors, as the loss of trust combined with intense activity of the competition may lead to resignation from using the services offered by a given entity. Thus, reputational risk, although not "material" in nature, may have very significant "property" implications for the financial result.

3 Real property and risk

Investing funds in real estate means, in addition to protecting the purchasing power of money, minimizing the risk of loss, as well as high return on investment[2]. However, as in any market (Geltner 1993, 325-346), without the appropriate knowledge and experience, the investment process (Ho 2008, 218-228) may turn out to be unsuccessful and the money invested may be lost. Therefore, before starting it, you should take all actions that will minimize the risk associated with the investment. Until the outbreak of the COVID-19 pandemic, the most popular forms of investing in real estate are currently investments in rental housing and real estate flipping. In the case of the first solution, the investor receives monthly rent from the landlords, which he can spend on current expenses. Depending on the standard of the flat or house, as well as other factors, such as the location of the property, it can generate about 6-9% of income annually. It is therefore a value several times higher than in a standard bank deposit, which additionally increases the popularity of buying apartments for rent (Emmer, Kratz, Tasche 2015, 31–60).

Due to low interest rates, it is attractive for a large group of investors to buy an apartment on a loan. The rent they receive from tenants often exceeds the loan installment, so in a way the tenants bear the costs of the financial obligation. After paying off the loan, the investor owns the apartment. In short, apart from own contribution, after 30 years the investor acquires the property for which he theoretically did not pay anything. Property flipping can bring even higher profitability. With appropriate knowledge, experience and a network of contacts, it is possible to generate from 7 to over 15% of profit annually. It is enough to find an apartment below the market price (Peng, Thibodeau, 2017, 34-375), renovate it and sell it at a profit. There are thousands of apartment sales offers on popular websites, so finding an investment opportunity is only a matter of time.

It is a big mistake to take into account the risk of a lack of tenants in the calculations, as well as the treatment of someone else's property by landlords. It is worth considering the money allocated to the renovation fund in the calculations. In order for an apartment to find tenants, it must be attractive and aesthetic, so it is worth refreshing it from time to time (e.g. repainting the walls, changing decorations or furniture), and carrying out a major renovation every 10-15 years. The launch of a renovation fund for future works reduces the profitability of the investment to 3-5% per year.

In addition to the factors mentioned above, the very calculation of profitability may prove problematic. The rate of return on investment is given on an annual basis (Stein, Piazolo, Stoyanov,

[2] http://www.thecity.com.pl/Rynek/Wiadomosci/Najatrakcyjniesze-sektory-nieruchomosci-w-2021-r

2015, 245–279). In the event of an increase in interest rates, the attractiveness of bank deposits will increase. There will be an outflow of capital from the real estate market towards the banking market. Investors who previously went in the opposite direction may return to investments by selling their flats (Lausberg, Lee, Müller et al. 2020, 3–27). Such a large-scale move will cause real estate prices to fall and lower their profitability. Buying real estate without checking whether the property is free from legal defects is a great risk. Verify that the seller has ownership of the property. Control of the legal status will exclude whether the real estate is not encumbered or limited by a property right (e.g. a mortgage (Shao, Hanewald, Sherris 2015, 76-90), usufruct or easement) or the right of a third party (rental, lease, lifetime property). On the real estate market, the investor faces two problems related to money: the limited capital he has and his creditworthiness, which limits his ability to purchase several apartments at the same time. In addition, it is also impossible to partially give up the investment undertaken, the real estate can be sold in whole or not at all (Herath, Maier 2015, 117–168).

The risk of each of the above-mentioned threats can be minimized. However, it cannot be denied that due to the coronavirus pandemic, 2020 was, to put it mildly, unusual. As the data analyzes[3] show, at present the chances of the cuts in home prices predicted by some are very small. The demand for apartments is still very high. Specialists see this for several reasons. First of all, people want to invest their money in real estate because it is a good protection for their property against inflation in a world of soaring prices. The interest rate on deposits is close to zero, so many prefer to invest in something that will translate into profit after many years. Real estate is understood as a safe and secure investment. Nowadays, an investment in an apartment seems to be an ideal plan for long-term capital investment.

4 Short-term rental and the COVID-19 pandemic

Although the importance of the short-term rental market has changed with the advent of the Internet and mobile applications, it has existed in a sense for centuries (Armstrong 1985, 71-72). In Western Europe, short-term rental gained popularity after World War II due to the increased demand for housing and the need to look for more economical solutions. Many cities around the world have many restrictions on short-term rentals. These regulations are often local in nature and vary from country to country and even city to city (Kaźmierczyk 2020, 192-193). Short-term rental laws in many countries vary considerably from state to state or region to region, including differences in how short-term rentals are perceived and short-term rental platforms operate.

Risks in the condo and aparthotel market can be divided into several basic categories. The first group concerns risky financing. This risk increases when the financing investment is made solely from consumer contributions or the sale of bonds[4]. The second group of risks relates to security issues. Another risk category includes uncertain profit. Often, the promised big profit may not be achievable as developers often do not take into account the costs of property management (Benedetto 2015, 24) and maintenance. Yet another group of risks concerns non-transparent cooperation, often consisting in the lack of clear rules of cooperation between developers and financial intermediaries or brokerage houses, often associated with banks. This type of risk also relates to the lack of transparent rules of responsibility of individual entities towards the consumer (Gnela 2013, 190-220). These entities specialized in their industry effectively encourage clients to invest their savings in aparthotels and often to take out loans for this purpose. In some countries, such as Poland (Belniak 2001, 40), short-term rental activity is currently not subject to applicable legal regulations in many areas, this applies to the construction process, protection of buyers of premises, tax and tourist issues, as well as protection of tenants.

As a result of the pandemic, there are few new buyers on the rental market. Potential tenants are lacking, especially in the case of the so-called short-term rental offers, which have so far been used most often by tourists and businessmen. Not only students, catering, trade and hotel industry employees have disappeared from the rental market, but also other employees who previously worked on contracts. A

[3] https://jrdelisle.com/jrd_text/1Chapter4_New_V17_L2.pdf
[4] Announcement of the Polish Financial Supervision Authority on alternative investments in real estate. of 25/09/2019, available at https://www.knf.gov.pl/o_nas/komunikaty?articleId=67218&p_id=18.

compulsory break in renting causes the owners to decide to improve the standard of their apartments in order to remain competitive. The time when they intensively search for new tenants, they use it for renovations and the so-called home staging. According to the data provided by advertising portals, studios and two-room apartments are much more popular during the pandemic. The hardest thing is to find tenants for rooms where you share bathrooms and kitchens with several other people. Three rooms seem to be the border. With four people there is much less interested.

5 Commercial real estate - the risk of an emergency

Lease contracts for commercial space (Bokhari, Geltner 2010, 635–670) in shopping malls are usually concluded many months before the opening of the store for customers, and the opening itself is preceded by many weeks of adaptation works in the premises. Renters of commercial space (Foryś 2008, 26-30) to well-known and large chains in shopping centers often have to compromise when negotiating lease terms. In this way, they gain a network that should ensure a constant flow of customers, as well as make leasing space (Palicki 2015, 24-35) more attractive for other tenants. After all, nothing scares off customers like empty spaces in shopping centers. During the pandemic, on the one hand, no trade for tenants of retail space, and on the other hand, this did not mean that entire shopping centers were closed (Badura 2020, 230-239). Thus, the landlords fulfilled their obligations by providing commercial space (Chen, Khumpaisal 2009, 238-258), and the tenant had access to the rented stores and from this perspective he was obliged to pay the rent. Moreover, many post-tenancy conflicts are caused by the issue of settlements. It is quite common for tenants to leave improvements (installations) in the premises without the need to settle them with the landlord, in return for which the landlord does not request removal of changes introduced by the tenant.

During the COVID-19 pandemic, many countries introduced numerous regulations to limit the spread of the disease[5], including a decision to suspend certain activities (Jankowska, Pawełczyk 2020, 17-18). Commercial premises were closed for many months, especially those located in shopping malls. Therefore, the tenant could not use the store in accordance with the purpose of concluding the contract, and therefore should not be obliged to pay the amounts due for this period. Unfortunately, the new regulations, often adopted ad hoc, raised many doubts from the very beginning. The parties to the lease agreements did not always conclude agreements in which they specified in detail mutual rights and obligations in the event of emergency situations, e.g. a pandemic. According to the common position of landlords, tenants should fulfill their obligations in accordance with the applicable *'pacta sunt servanda'* principle (Lekkas, Tzanakopoulos 2014, 335).

Most European legislation regulates situations where the performance of a contract has become objectively impossible due to circumstances for which neither party is responsible. The introduction of a ban on operating in open stationary stores meant that tenants could not use the store in accordance with the purpose of the lease agreement. The tenant pays for the use of the store that may be open, and not for owning the store. Due to the adopted regulations, the landlords, objectively and for reasons for which neither party was responsible, were unable to provide the services that would fulfill the parties' consent expressed in the commercial space lease agreement. Thus, tenants could not demand the lessor to provide a benefit in the form of providing a commercial space in which the tenant, from the point of view of the contract with the landlord, is obliged to conduct commercial activities, but the landlord cannot demand payment of rent and other fees.

Due to the temporary and partial impossibility of performance, it should be considered that the obligations of the parties have expired for the duration of the prohibition (Gnela 2012, 178). Due to the inability to provide the lessee, the tenant is exempt from the obligation to bear the costs of renting commercial space. It does not change the fact that as a result of the trade ban, it does not obtain revenues from its activity. In the event that the tenant was obliged to pay fees under the lease agreement despite

[5] In some countries, restrictions were determined by area. For example, in Poland, the suspension did not apply to tenants operating in shopping centers with a sales area of less than 2,000 m2 (even if the tenants were banned) or in buildings other than shopping centers (e.g. office buildings, warehouses).

the prohibition of commercial activity in force, it would mean that the sole risk of trade would be borne only by him. Such an approach would grossly violate the principles of contractual justice.

For this reason, the rights and obligations of the parties under each rental agreement must always be considered individually. The "*rebus sic stantibus*" clause (Kulaga 2020) can be viewed as a statutory material adverse change clause, which is an extraordinary change of circumstances (Janssen, J., Bert K., Needham, B. 1994, 237-252). Pursuant to the "*rebus sic stantibus*" clause, neither party may terminate or amend the contract on its own. Only the court can change or suspend certain obligations and even terminate the contract. In order to apply the "*rebus sic stantibus*" clause, the aggrieved party must prove that an extraordinary change of circumstances has occurred and that such a change causes undue difficulty in fulfilling the obligations of the party or threatens such party with a significant loss. The change of circumstances should be permanent. When considering the risk of significant losses, the commercial purpose of the contract should be taken into account. If a tenant is renting out premises for the purpose of doing business and making a profit, it should be clear that the prohibition to operate in the premises causes considerable loss for the tenant.

The expiry of mutual obligations during the period of the commercial prohibition means that the parties are temporarily released from the obligation to provide the other party with what the parties have agreed to do in the lease. Temporary expiry applies not only to lease agreements, but also other agreements similar to lease agreements, under which commercial space is made available, including any commercial space, e.g. stands. It seems that "mutual obligations" should be understood specifically as obligations of both parties to the contract, while the exemption from the obligation to perform only applies to those benefits / services that become due during the prohibition period.

Summary

In addition to numerous advantages, investing in real estate also has many disadvantages, including low liquidity, which results, for example, from the sale procedure. Another disadvantage is the indivisibility of the real estate, which means that only shares and not parts of one real estate can be sold. It is also important to manage the property, investing in it in order not to allow for loss in value as a result of renovation or maintenance negligence necessary over time. There are many categories of risks related to the functioning of the real estate market, as well as many subcategories of legal risks. Real estate is commonly considered one of the least risky forms of investing capital. Competitiveness in the real estate market is likely to increase as the hospitality and retail companies that have suffered the most from the economic freeze are now thinking of switching to housing production. And it is multi-family properties that may emerge from the 'post-COVID-19' crisis unscathed as one of the stronger asset classes. However, the condition of a given economy will be of key importance for the real estate market. It is closely related to the general economic situation in a given country.

The short-term rental market has so far seemed to be a safe haven for investors looking to profit from real estate. The current situation has significantly changed the existing rules. Due to the fact that the short-term rental market is closely related to the hotel and tourist industry, according to experts' forecasts, also this group may lose financial liquidity in the near future. Temporary closure of borders, limitation of international and domestic connections, and above all the introduced state of epidemic threat as a consequence result in a marked decrease in interest in short-term rental. On the other hand, the COVID-19 epidemic has severely hit tenants of commercial premises in shopping malls operating in various industries. Tenants' problems can be differentiated depending on whether it was the lease of commercial space to run shops or service points or the rental of office space (Chen, Hobbs 2003, 66-75). Undoubtedly, however, taking into account the situation on the market, it should be stated that while landlords, who unfortunately are usually accused of being too rigidly attached to the existing terms of the contract, with the undoubtedly changed economic reality, will not start presenting a more flexible approach and agreeing to significant contract modifications. lease, one should expect an increase in many interesting lawsuits.

Low-interest deposits, cheap loans, combined with a complete defrosting of the economy, may cause an increase in real estate prices at the beginning of 2021. Investors in rental housing during a pandemic must take into account an increased risk. The risk factors include not only the further development of the global pandemic, but also domestic factors, such as rising unemployment, wage cuts in many sectors or problems with short-term rentals. If someone has a lot of capital to invest and will only use a bank loan to a small extent, then he should think about the possibility of buying an apartment for rent. With a high mortgage for this purpose, there is a risk of an increase in interest rates in the future, which will make the obligation more expensive.

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