

REITs and Leases

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On 13 September 2016, Securities Commission Malaysia (“the SC”) issued a Consultation Paper¹ inviting public feedback on proposed changes to the REIT Guidelines.² One significant proposal was to allow REITs to acquire “private leases”. In the Consultation Paper, “private lease” means “a long-term lease agreement with a lessor where the lessor is not a government or a government agency”.³

Although the current REIT Guidelines do not expressly prohibit acquisition of real estate in the form of leases, there has been some confusion as to whether a REIT is allowed to acquire leases at all, and if so, within what parameters.

Terminology

The use of the term “lease” and related words in the REIT Guidelines are ambiguous and inconsistent. For example, in the case of a “leasehold real estate”, the REIT Guidelines require the management company to ensure that —

“(a) the consent of the relevant authority to transfer the lease has been obtained before the fund’s prospectus is registered with the SC (or

where it is an excluded offer, the information memorandum is deposited with the SC), or prior to the acquisition of the leasehold property (in the case of an existing fund); and

“(b) the lease must be a registered lease.”⁴

Under the National Land Code 1965 (“the NLC”), a “lease” means a registered lease or sub-lease of alienated land, whether it is granted by the proprietor who holds such alienated land in perpetuity or for a term of years.

Alienated land granted to a proprietor and held under a register document of title for a term of years is called a “State lease”⁵ or, colloquially, as a “leasehold title”, as opposed to a “freehold title”,⁶ which is a grant in perpetuity.

Although the term “real estate” is often taken to include derivative rights such as a lease,⁷ the REIT Guidelines define it as meaning only “land and all things that are a natural part of the land as well as things attached to the land both below and above the ground”.⁸

Ambiguity

Therefore, where the REIT Guidelines make reference to a “leasehold real estate”,⁹ it must be taken as referring to what most people would call a “leasehold title” granted by

1 The SC’s Public Consultation Paper No 3/2016 (Proposed Amendments to Guidelines on Real Estate Investment Trusts and Streamlining of Post-Listing Requirements for Listed Real Estate Investment Trusts with Listed Corporations)

2 Guidelines on Real Estate Investment Trusts issued by the SC (effective 21 August 2008 and updated 28 December 2012)

3 Consultation Paper, para 2.7

4 REIT Guidelines, para 8.13

5 NLC, s 5: “State lease” means “a register document of title in Form 5C (that is to say, in the form appropriate under this Act to land held under Registry title for a term of years)”

6 Also known as “grant” under s 5 of the NLC: “grant” means “a register document of title in Form 5B (that is to say, in the form appropriate under this Act to land held under Registry title in perpetuity)”

7 See, for example, the Main Market Listing Requirements of Bursa Malaysia Securities Berhad, which define “real estate” to mean “land and all things that are a natural part of the land as well as things attached to the land both below and above the ground, and includes the rights, interests and benefits related to the ownership of the real estate”

8 REIT Guidelines, para 2.01

9 “State lease” in the terminology of the NLC

the State. This would exclude a registered lease created by the proprietor of the real estate (whether leasehold or freehold).

What then would be the purpose of sub-paragraph (b) above, requiring that “the lease must be a registered lease”, given that all “leasehold real estates” are registered with a document of title¹⁰? Sub-paragraph (b) must therefore be construed as allowing a REIT to acquire leases granted by a proprietor of land or “real estate”.

Another source of ambiguity is in how the SC views the term “private leases”. There appears to be a distinction in the Consultation Paper between “acquisition of properties through direct ownership”, which grants a REIT “legal ownership of the properties”, and “private leases”, which grant the REIT “beneficial interest derived through a lease agreement”.¹¹ It may be that a lease agreement grants contractual rights but a registered lease under the NLC confers registered interest and not merely beneficial interest.¹²

The distinction made by the SC between a “private lease” and a “lease entered into with a government or government agency” adds to the ambiguity:

- (a) a lease granted by the State or the Federal government would be a grant of alienated land, a *State lease*;
- (b) a lease granted by the proprietor of alienated land which happens to be a government agency will not confer any more rights than if it was granted by a proprietor which is not a government agency, a *registered lease*.

The key is whether the lease is registered or not against the title of the land. Therefore, the distinction implicit in the term “private lease” must have been prompted by cases where REITs have acquired leases from what can be considered government agencies, for example:

- (1) The 44-year sub-lease granted by Pelabuhan Tanjung Pelepas in favour of Axis Real Estate Investment Trust;¹³ and
- (2) The 99-year lease granted by Kemajuan Negeri Perak in favour of YTL Hospitality REIT which houses the Pangkor Laut Resort.¹⁴

Both these leases would be considered registered leases under the NLC. So the distinction between a lease which

10 NLC, s 5: “document of title in relation to any alienated land, means both the register document of title and the issue document of title relating thereto, save that, in the case of land held under qualified title in respect of which no application for an issue document of title has been made by the proprietor, it means the register document of title only”

11 Consultation Paper, para 2.9

12 NLC, s 227 (Effect of leases and tenancies):

(1) The interest of any lessee, sub-lessee or tenant shall, whether or not it takes effect in possession, vest in him on registration of the lease or sub-lease or, as the case may be, the grant of tenancy.

(2) The said interest shall include the benefit of all registered interests then enjoyed with the land to which it relates.

13 <http://ir.chartnexus.com/axisreit/website_HTML/attachments/attachment_5106_150724235400_4487.pdf>

14 <http://www.ytlcommunity.com/annualreport/pdf/YTLHospReit_AR2016.pdf> (see page 28 of the annual report)

confers beneficial interest and a registered lease does not therefore depend on the identity or status of the lessor.

The Consultation Paper shows a clear intention on the part of the SC to allow REITs to acquire properties in the form of leases, although the existing REIT Guidelines do not expressly prohibit it and can be construed as permitting it given the ambiguities given above.

In either case, it would be of value to examine some incidents of ownership of leases registered under the NLC.

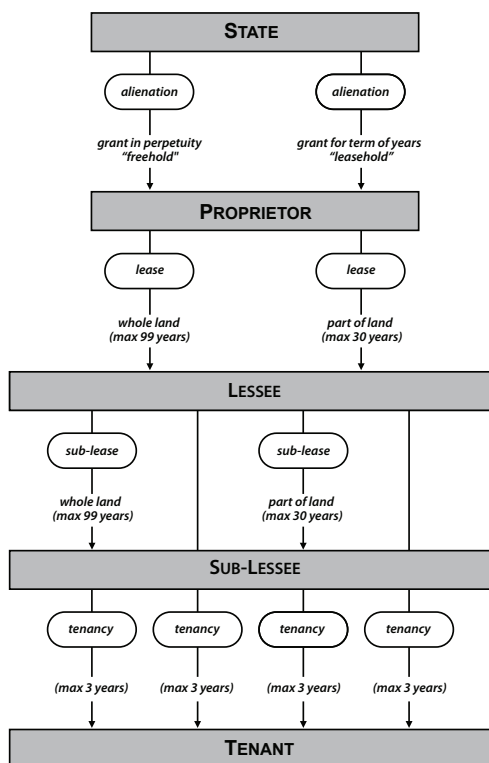
The registered lease

The NLC allows proprietors to create leases for a maximum term of 99 years if it relates to the whole of any alienated land and 30 years if it relates to only a part of the land.¹⁵ Sub-leases can be granted out of any registered lease or sub-lease. If a sub-lease so granted relates to only a part of any alienated land, it is subject to a term of not exceeding 30 years.¹⁶

A REIT can therefore acquire registered leases (maximum of 99 years) and sub-lease (maximum of 30 years) and add them to its portfolio of assets and then grant sub-leases or tenancies as it could with other properties.

A registered charge can be created over the lease or sub-lease as security for financing as it can with registered titles.¹⁷

Alienation—Lease—Sublease



15 NLC, s 221

16 *Ibid*, s 222

17 *Ibid*, s 241(c)

Flexibility

Most REITs operate under the perception that the current REIT Guidelines do not permit acquisition of registered lease and restricted their portfolio to properties with individual titles. One of the benefits of allowing REITs to acquire private leases is that REITs can now be more selective in making their acquisitions. REITs can now take up a lease for only the prime portion of the alienated land or development and not be compelled to acquire the less profitable parts. It also allows flexibility to proprietors which may not prefer to sell their properties outright.

Whether a REIT holds property as owner or registered lessee, it would have the same rights against its sub-lessee or tenant.

Concerns

Private leases granted for only part of any land or building will mean that the REIT may not have full control over the management of the entire property. For example, the REIT may not have full control over the use of the remaining part of the land or building by the proprietor or other lessees and tenants which may affect the value or rentability in the area if such use causes the value to fall below par.

In the case of developments with strata title, issues may arise concerning the common areas of the property accessible by other occupiers. It may be prudent for the REIT to ensure that it commands a majority of the voting rights where the management of building or land is

concerned. For example, CapitaLand Malaysia Mall Trust owns only 205 parcels of Sungei Wang Plaza representing only approximately 61.9% of the aggregate retail floor area,¹⁸ giving them majority voting rights of 62.8% in the management of the plaza.

The holder of registered lease is subject to any restrictions and conditions on the title to the same extent as the proprietors. As a sub-lessee, the REIT will in addition be subject to any covenants in the head lease between the proprietor and the intermediate lessor.

Risk management

A way to manage the concerns mentioned above is to ensure that covenants are carefully drafted in the lease agreement so that the rights and interests of the REIT are not prejudiced:

- (a) Full enjoyment of the property by the REIT including the right to income and the lease should not contain any restrictions on sub-leasing and sub-letting.
- (b) Careful attention must be paid to any easement which exists and which the REIT may require for full enjoyment of the property.
- (c) All default and provisions for termination by the lessor must be closely examined to ensure there is no unnecessary exposure to forfeiture or legal action.

18 <[http://capitamallsmalaysia.listedcompany.com/newsroom/CapitaLand_Malaysia_Mall_Trust-AR2016_\(20170227\).pdf](http://capitamallsmalaysia.listedcompany.com/newsroom/CapitaLand_Malaysia_Mall_Trust-AR2016_(20170227).pdf)> (see p 87 of annual report)

- (d) It may be necessary to procure specific covenants from the lessor to prevent any situation which may lower the value of the building. Policies and rules concerning the management corporation and any deed of mutual covenant of strata title holders should be vetted to ensure that the interests of REITs are not compromised in any way.
- (e) A shorter lease with option for extension or renewal cannot be considered as equivalent to a lease for a full term. Renewal clauses can be fraught with difficulties.

In order to safeguard the interests of REITs, the Consultation Paper sets out conditions for private leases such that:

- (a) The lease must be registered with the land office;
- (b) The total value of private leases with remaining lease period of less than 30 years should be less than 25 per cent of the total asset value (after acquisition) of a REIT;

- (c) The management company of the REIT must obtain legal advice on the acquisition of the private lease; and
- (d) The management company must provide additional disclosures including the remaining term of the lease, name of lessor, whether the lessor is a related party, etc.¹⁹

Conclusion

The industry is looking forward to the clear stamp of approval from the SC in the revised REIT Guidelines to bring greater clarity so that business decisions to venture into leases can be made with more confidence. **LH-AG**

¹⁹ Paragraph 2.10 of the Consultation Paper